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Impact Through Innovation

Roundtable

Embedding impact in investment funds

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Foreword

by Emmanuelle Dotezac
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Impact investing directs capital to enterprises that generate social or environmental benefits as well as financial returns to investors. It is a rapidly growing industry powered by investors who wish to make a tangible positive impact as well as profit. Indeed, social and environmental impact objectives increasingly go hand-in-hand with attractive financial returns.

According to the GIIN's recent report, released in October 2022, the worldwide impact investing market has grown to US$1.164 trillion – signalling the first time ever that the total value of impact assets under management has exceeded the trillion-dollar mark. And despite the turbulent macroeconomic headwinds, impact allocations appear to be staying strong.

As impact becomes increasingly mainstream, fund managers must determine, implement and clearly articulate their impact strategy in order to attract impact-focused investors. With rising concerns about greenwashing and growing sustainable finance regulation, we're seeing a distinct shift from "tell me" to "show me", with more pressure being placed on managers to show real evidence of the claims made in their marketing materials and to demonstrate how impact is embedded throughout the fund's lifecycle.

On 18 October 2022, IQ-EQ joined forces with specialist impact investing advisory firm Innovest Advisory to host an in-depth roundtable at our London office, focused on the effective embedding of impact throughout the investment fund lifecycle.

Featuring a select group of experienced impact fund managers and advisers, the dynamic discussion included an abundance of first-hand experiences and fascinating examples relating to everything from finding the right commercial opportunity, through the quirks of impact due diligence and risk mitigation, to how to measure results and where to draw the line in ensuring on-the-ground impact.

Together, the group showcased how best to integrate sustainability criteria in the investment process and addressed a number of hot topics including impact-related financial incentivisation and the challenges presented by sustainability regulation, specifically the European Commission's Sustainable Finance Disclosure Regulation (SFDR) and their 'Article 9' fund classification, which requires sustainable investments to be the fund's primary objective.

What follows in this whitepaper is a detailed summary of the October session split across a number of key themes, which each deliver real insight into the opportunities, hurdles and future of impact investing. I hope you find the commentary as useful and interesting as I did being part of it.

Participants

Emmanuelle Dotezac (moderator)
Director, Funds
IQ-EQ

Justin Sykes
Managing Director
Innovest Advisory

Guillaume Leredde
Director
Avardi Partners

Nathalia Millan
Head of ESG for Private Equity
Tikehau Capital

Katherine Mulhern
CEO
Restitution

Tom Powell
Founder and MD
Amthe Capital

What ‘impacts’ are being invested in?

It’d be no understatement to describe the impact fund managers gathered around IQ-EQ’s boardroom table on 18 October 2022 as diverse, with specialisms ranging from climate to cattle. This small group of experts alone showcase the array of worthy investment strategies able to qualify as ‘impact’.

For example, Restitution, represented at the roundtable by CEO Katherine Mulhern, is one of the first impact fund managers that invests in assets that align with UN Sustainable Development Goal (SDG) 16, ‘peace, justice and strong institutions’. A litigation funder with a difference, Restitution assists newly democratic governments in their fight against corruption by providing funding and support for civil enforcement and asset recovery. Restitution develops claims, judgments, awards and non-performing loans as a portfolio of assets, putting them into a fund where the government invests side by side with impact investors to maximise results, while ensuring that returned funds are protected against re-corruption.

Responding to the climate emergency

While Restitution is a particularly unique case, broader discussion around impact verticals pointed towards environmental impacts as seeing the greatest engagement, with Innovest’s Justin Sykes asserting that “climate technologies and natural assets are definitely the fastest growing areas in the impact space”.

This is certainly reflected by the strategy of Tikehau Capital, whose Head of ESG for Private Equity Nathalia Millan was also part of the conversation. Talking about the progression of Tikehau’s impact investing journey since the launch of its first energy transition fund in 2018, Nathalia highlighted the firm’s continuing focus on climate, decarbonisation and biodiversity – with one of its newest funds taking things a step further by targeting regenerative agriculture, one of the few available solutions for carbon sequestration and therefore a key area in the fight against climate change.

“We know that even if we halve carbon emissions by 2050, it isn’t enough to keep global warming below two degrees, which is why we’re now looking towards regenerative solutions,” she explained.

It is no surprise that the environment is top priority given the increasing global focus on the climate emergency. That being said, Amthe Capital founder Tom Powell also noted that “while flows around climate change and the environment have been a lot more audible and visible, we are seeing a growing social component as well, looking at poverty alleviation in particular.”

Justin similarly observed that the social development focused impact investment themes of agriculture, financial inclusion and SME financing are three key areas of consistent activity.

Just transition: linking environmental and social

Tom and Justin went on to concur that, in fact, there is increasing overlap between environmental and social impacts. Tom highlighted the need for education investment to drive people’s ability to implement environment-related initiatives – “because without the education you’re just throwing money away. You need to teach people how to use and maintain renewable energy technology and such like.”

“The focus on climate cannot be divorced from human development.”

With regard to emerging markets in particular, Justin observed that “the focus on climate cannot be divorced from human development” and noted the number of funds now coming to market that are factoring this into their investment strategy. “They recognise the need to support the climate transition in emerging markets in a way that preserves existing jobs, creates new jobs and, ultimately, does not further impoverish vulnerable populations.”

This approach is also being driven at the LP level, for example by the Emerging Markets Just Transition Investment Initiative, a body launched this year by 12 UK pension funds, led by the Church of England Pension Board.

“Just transition initiatives are channelling significant institutional capital towards managers either investing into or based within emerging markets, with the goal of achieving climate transition in a manner that addresses underlying social justice issues which – if not considered – would create further challenges in already-stressed markets,” said Justin, “especially in the context of the current cost-of-living crisis, inflation and food pricing issues.”

Finding the commercial opportunity

With such ongoing market volatility, the need to protect people and planet is balanced carefully with the need for healthy financial returns, and close attention is being paid to which funds are performing best. Around the table, talk turned to the commercial side of impact.

Sustainable = profitable

Over the years, as impact investing has evolved and come to the fore, much attention has been given to the apparent 'trade-off' between impact and profit, but this line of thinking is fast becoming outdated. In reality, the two are inherently linked.

"Given the investment model we use, there can be no financial return without impact and vice versa," commented Amthe Capital's Tom Powell. "Our goal is to create sustainable businesses, to fully divest and leave wholly owned domestic subsidiaries or independent companies with no ongoing input from us. If a business isn't profitable, people won't continue to do it. Profitability is in everyone's best interests."

Nathalia Millan concurred, citing one of the Tikehau Capital convictions: "To be sustainable, a company needs to be profitable, and to be profitable it needs to be sustainable."

Nathalia also highlighted the resilience of impact funds given their significance in today's global landscape. "What we're seeing with our energy transition fund is that its investments have remained resilient in spite of both the pandemic and the current economic crisis. They're continuing to deliver significant financial returns because the theme of the fund is so pertinent in today's environment."

Speaking about the impact fund managers that Innovest works with, Justin Sykes conclusively stated that "whilst some fund managers focused on investing in challenging contexts are intentionally seeking concessional investment and are coming to market with sub-commercial investment strategies, the vast majority are seeking market rate returns and there is no trade-off between commercial and impact objectives."

A study in dairy

So how can managers home in on the investment areas with the greatest potential for both financial and environmental or social returns? To answer this question, Tom shared insight into the strategic selection process of Amthe Capital, which aims to create sustainable dairying businesses and grow the dairy economy in Africa, building upon the work done in recent years by Jersey Overseas Aid and the Royal Jersey Agricultural and Horticultural Society to establish the breeding of Jersey-quality cows in the continent.

"For Amthe, we've selected our focus regions based upon the ease of doing business there," said Tom. "With some countries – for example, Botswana, which is on the list to become the next desert in Africa – the investment would be hugely beneficial in the short term, but the long-term picture is less positive. Fighting a clearly identified climate shift, you can predict that investment capital will be eroded over time by migration and environmental degradation. As a small private fund, we must focus on where we have the highest chance of success.

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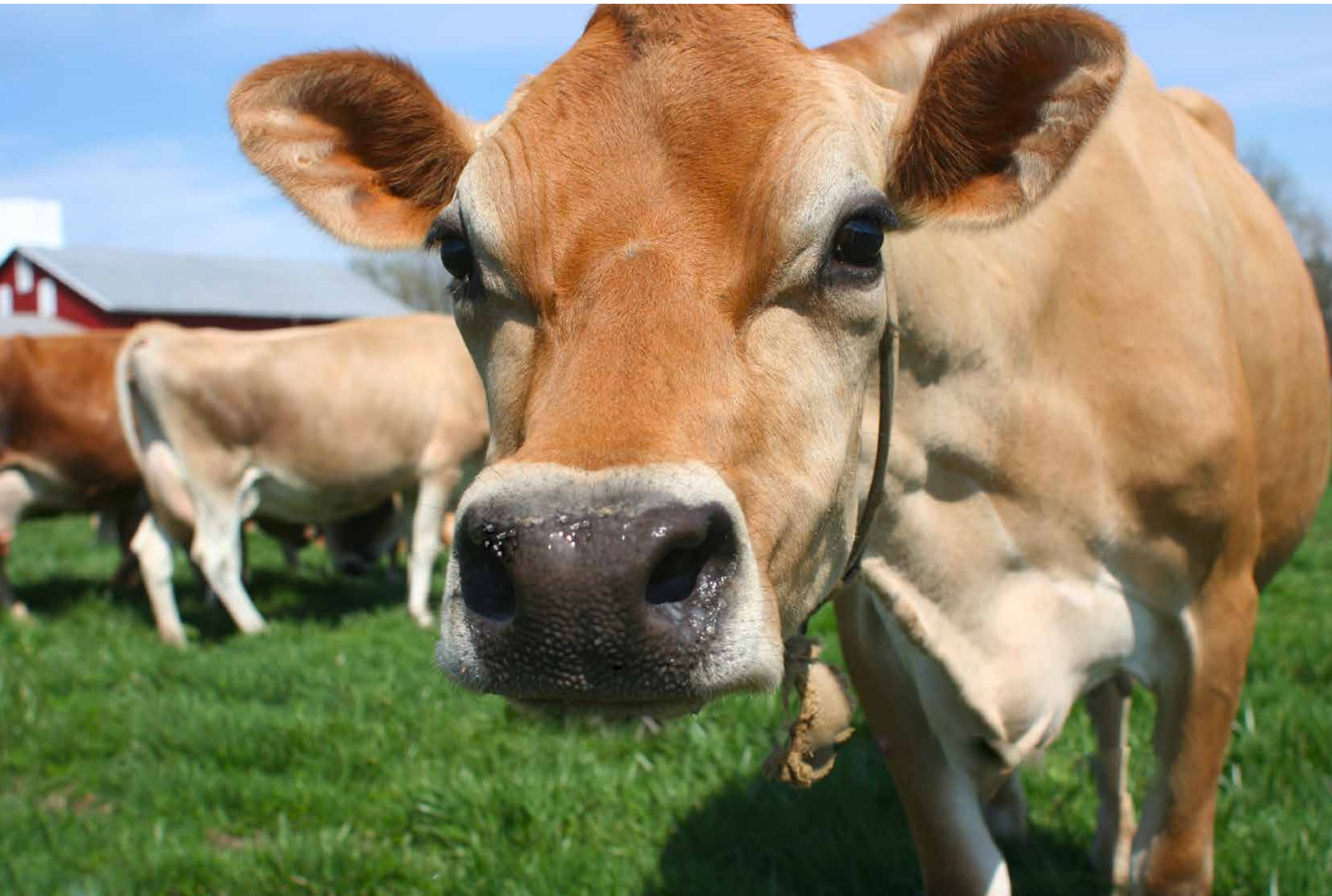
"In terms of ease of doing business, we also look at factors such as: Are there stable governance structures nationally? Is there a dual tax agreement between where our investment is coming from and where it is going? Can we realise profits both domestically and for our external overseas investors?

"Once that's all been established – we've got the free flow of capital sorted, we know we can hold equity positions, we can enforce debt positions, and so on – then we examine whether there's a level of education suitable for training up artificial insemination technicians, paravets, milking technicians, technicians who maintain refrigeration systems, et cetera. At this stage, you really start weeding out many places where investment is impossible unless you have vast amounts of capital and a high loss ratio. The reality is that this process of elimination brings us to markets where there has historically been dairying.

"Rwanda, for example. We identified that their dairy industry has around 1.2 million cows. Their milk output is quite literally a drop in the ocean compared to that of the much smaller but hugely more productive Jersey dairy industry. Similar can be said for Kenya, northern Tanzania, southern Uganda. So, there's huge opportunity for positive and financially lucrative impact in these countries – by replacing a very inefficient process with a highly efficient one."



Ensuring effective impact due diligence

Rather than focusing on profit versus impact, Justin Sykes suggested the challenge is more around the risk of over-stated claims and ensuring impact attainment. To this end, specific impact due diligence is critical.

What constitutes impact due diligence?

"Due diligence is a standard part of our investment process," stated Tikehau's Nathalia Millan. "In terms of impact, our investment team works with specific experts who handle impact assessments. We have created guidelines to assess fit with our impact funds, as well as a dedicated governance process through an Impact Committee, addressing and validating new investment opportunities. To pursue this endeavour, we try to stick as much as possible to scientific research. For example, for our T2 Energy Transition Fund, we use the IPCC scenarios for Net Zero to identify if an investment opportunity could fit the fund's impact intention.

"Using a holistic approach, we consider both positive and negative impacts as well as non-financial risks. Regarding climate, which is among our core priorities, the due diligence takes into account potential climate-related negative impacts and risks, how a company is working to reduce its carbon footprint and also whether it's addressing climate-related risks like flooding.

"For example, if the company we're looking at is focused on building renovations, we'll read the IEA and IPCC reports on buildings. We'll know from this that boilers using natural gas are OK until 2025, but after this date we need to be using heat pumps instead. So, we need to establish the company's activity and plans in this regard."

The assessment of impact overlaps with consideration of ESG criteria. Nathalia continued: "We also try to ensure the investment opportunity represents 'no significant harm' in ESG terms. We call this the 'ESG basis'. We conduct a red flag assessment and assess a company's ESG maturity. This also gives us an excellent start point for any potential roadmap that we might look to put in place for the company following investment and for annual monitoring going forward."

The story is a little different for Restitution, where – as Justin put it – "instead of due diligencing assets or companies, you're due diligencing country situations." What's more, Restitution's Katherine Mulhern noted that the governments they partner with are transparency-focused, and will decide for themselves if they want the entire approach that Restitution offers. As a result, these governments will "self-select". She also stated that initial contact may come from the governments themselves, or from those outside of government who have a granular knowledge of the situation in the country: "In many cases, we will get contacted by a senior societal figure (for example, a senior religious leader), who will raise a particular issue in the country that needs to be addressed. Prolonged mistreatment of fishing communities, for example.

"At this stage, our first-level due diligence will involve speaking to people in the country to find out more about the claims being made. We also have in-house experts in policy, government and human rights, and we run the opportunity through our own quantitative analysis, examining the situation in country and how a country ranks in various indices relating to transparency and human rights, for example.

"The final touchpoint will be establishing whether we have champions within the government who we can speak to, and that first outreach will tell us a lot. We have had governments who've said thanks but no thanks. But the governments who are interested are really interested; they go in 100% and are fully committed to achieving positive impact."

Embedding impact in the investment process

For newer investment firms like Restitution and Amthe Capital, which were established with a specific impact goal in mind, impact is embedded within due diligence process from the outset. But what about for more establish managers, such as Tikehau Capital, that have made the shift into impact at a later stage? How are impact and commercial due diligence harmonised?

"We have a small ESG team at Tikehau but we believe that responsibility doesn't just sit with us. The investment team needs to be fully engaged with the strategy for it to work. So when it comes to impact funds, we put a lot of effort into ensuring the investment team really embodies the strategy, with the ESG team stepping in more where there is a technical question that requires a specialist input.

"In addition, Tikehau has put in place an impact committee at a Group level, which takes place within the investment committee," shared Nathalia. "Everything discussed on the impact side of things is also heard by the wider investment committee, meaning that everyone is aligned with the impact strategy. We make it clear within our governance process that equal weight is given to impact.

"Everything discussed on the impact side of things is also heard by the wider investment committee, meaning that everyone is aligned with the impact strategy."

"For each investment opportunity, the investment team needs to present an investment memo, which includes a section on impact, clearly demonstrating to the committee how the opportunity fits with our strategy and what due diligence questions they're going to ask to make a proper assessment. The impact committee is able to stop an opportunity if there isn't a clear fit. Where there is potential, the committee can also ask additional questions for due diligence. Once due diligence has been conducted and it's time to present to the wider investment committee, the impact committee again has a role to validate if the due diligence responses are sufficient and there is no risk of negative impact or reputational harm."

Guillaume Leredde, Director of fund finance advisory Avardi Partners, agreed with Nathalia's point about shared responsiblity, noting that smaller funds "might only have a single ESG person trying to adapt internal processes while staying in line with the investment strategy of the fund. If the fund really wants to be an ESG/impact fund, it requires the involvement of the entire investment team."

In-house or outsourced expertise?

Picking up on Tikehau's internal impact committee, Guillaume also highlighted different strategic approaches to impact due diligence in terms of outsourcing. Avardi Partners provides specialist advice, support and assistance to fund managers seeking to establish, refinance or renegotiate debt facilities at fund level, and in this capacity, they too are witnessing the increasing prominence of ESG criteria and impact goals. "In contrast with Tikehau's approach, I have a client who partners with an ESG specialist that approves all of their investment decisions from an ESG perspective, so the process is partly externalised," shared Guillaume.

Justin observed that "typically, larger managers have the ability to build or buy a full in-house solution and they run with that, while small to medium managers tend to outsource to expert third parties. But there's also an element of philosophy: do you build in-house and have that core capability, or do you work with someone external because of the need for transparency and third-party verification? It's important to make sure you're not marking your own homework and that your impact activity is in line with leading practices and can stand up to the scrutiny of the market. There are two schools of thought, both are continuing and there's no right or wrong – yet."

Nathalia suggested, to the agreement of the group, that impact due diligence requires a hybrid solution. "At Tikehau, we have the internal expertise and procedures but we also systematically have due diligence conducted by unbiased external third parties. We make assessments and decisions internally but it's important to have expert insights. ESG is a very broad area and it's hard to be an expert in all respects, so it's important to welcome focused expertise from dedicated third parties. These third-party assessments could take place both during the investment decision-making stage and as part of the annual review process, for example with the carbon footprint assessments and the validation of science-based targets."

"It's important to make sure you're not marking your own homework and that your impact activity is in line with leading practices and can stand up to the scrutiny of the market."

Mitigating impact risk

As with any investment, impact investing comes with risks – from not having enough time to conduct thorough due diligence, to not getting the environmental or social results that were promised. During our roundtable, the group discussed a variety of risk factors and how to deal with them.

When time is of the essence

As Tikehau's head of ESG for private equity specifically, Nathalia Millan recognised the advantage she has in terms of time. "In the private equity space, you typically get at least four weeks and privileged access to the management to work through impact due diligence assessments and seal the deal. The situation is different for our private debt team, who typically have less direct access to the management, and for the fixed income team who tend only to have three days or one week max."

In these much tighter conditions, how can impact risk be effectively mitigated? "For debt financing, we are putting in place ESG ratchets, aligning the credit margin to our ESG KPIs," shared Nathalia. She added that her colleague Vincent Lemaitre, Head of ESG for Private Debt, is on the UN PRI's Private Debt Advisory Committee and has been working on official standards for private debt ESG ratchets to make sure this type of activity is de-risked in terms of ESG moving forward.

With regard to fixed income and liquid strategies in general, Nathalia is of the view that "the lack of time for assessments is balanced by information being more readily available."

Amthe Capital's Tom Powell agreed: "Speed of assessment versus risk is a really important factor. When you're dealing with a publically listed entity or a pre-screened secondary market debt, that helps, but broadly speaking it's impossible to act quickly without risks growing exponentially."

Contracts and clauses

And what about when investment has been made, then the picture changes? In this scenario, Restitution's Katherine Mulhern highlighted the importance of solid paperwork.

"A lot of the work we do rests upon effective contracting and fund structuring. Essentially, the government puts their claims into a fund in exchange for an economic interest in the fund and other support that is part of the Restitution offering. This allows them to receive the recovered assets back as they are recovered over time, and quickly. However part of the agreement we have with them covers the entire process, including the use of assets and profit once returned. This can include, for example, an education fund, environmental fund or sovereign wealth fund. This way, if we end up in a scenario where the government changes and doesn't want to comply anymore, there are mechanisms in place that allow Restitution to continue its work."

Nathalia similarly shared that Tikehau's established approach is to include an ESG clause in their shareholder agreements, "which puts in place binding commitments to developing an ESG roadmap, taking a carbon footprint assessment, and so on. This legally binding commitment helps mitigate risk. In 2022 for example, we started to include science-based targets within the legal documents."

Innovest's Justin Sykes noted that locking commitments into the investment documentation is leading practice. "You then have a roadmap developed on the basis of those commitments that you can follow on a regular basis with a portfolio company's board and management."

Partnerships for the greater good

Addressing the group, Justin then queried what happens in the event of a material breach of those commitments – divestment? In response, Tom shared that his "other hat" is private lending, specifically commodity trade finance, which involves very strict ESG criteria that companies must adhere to before they can access the capital.

"We've had instances where a very low scoring company has come to us saying, 'Look, we know we score low. Help us put in place a roadmap to achieve better.' This then becomes an interactive process where we work with the company to implement an ESG policy and process and drive them forward – and we've achieved great success in this regard.

"Divestment is the worst option, as the company will find capital elsewhere, but you won't have achieved anything for the environmental or social issue you are seeking to support," said Tom. "Instead, keep them with you, blend in coaching and collaboration to get a positive result and achieve that impact alongside financial gain."

Agreeing with the merits of active management, Nathalia shared the example of when one of Tikehau's portfolio companies was struggling to put in place a sustainability strategy. In her example, it was clear that the company's products and services had a positive impact; they just needed to achieve consistency between what they sold and what they did internally. "Using an ESG engagement strategy rather than a divestment strategy," she said, "we decided to put ESG criteria into the bonus system for the company's management. We rapidly witnessed the positive effect of this initiative."

Incentivising impact

Continuing on the theme of financial incentivisation, the roundtable group examined the rationale and options for incentivising impact attainment at fund manager level. A few different views were expressed.

Avardi Partners' Guillaume Leredde asserted that "everyone should have the common goal of the impact being made, and one of the best ways to motivate people is to link this impact with financial remuneration."

Using financial reward to achieve alignment

"I've yet to see the impact-related incentives approach used widely in the private equity world," continued Guillaume, "but there are some fund managers focused on energy transition who are setting the team a specific target around the reduction of carbon emissions. This impact will be tested at the end of the investment period, and if the target is met, they will receive a certain percentage of the commitment of the fund.

"This approach wouldn't work for every company or every impact goal, but where there are clear, measurable impacts it could be a real game-changer in terms of the fund manager's mindset. It will be interesting to see over time if it is in fact sufficient to just focus on the remuneration of the fund manager, or is there a need for incentivisation at asset level as well. I think it will be a combination. In any case, I think financial incentivisation relating to impact is the right direction."

Tikehau's Nathalia Millan agreed that financial incentives present an opportunity, observing that many people working in private equity these days are keen to have a sense of purpose in what they do, so the double objective fulfils this desire and motivates everyone to share the impact responsibility, as opposed to it just sitting with the ESG team.

"For me, this is good practice, and I think we can also use this approach to incentivise and motivate portfolio companies to make sure that everyone from portfolio company level to top management is aligned with the impact strategy we're putting in place."

"Everyone should have the common goal of the impact being made, and one of the best ways to motivate people is to link this impact with financial remuneration."

The question of impact carry

Debating the merits of impact carry specifically, Restitution's Katherine Mulhern flagged that impact-linked reward can have far from the desired effect. "The issue with impact carry is that, let's be honest, it is hard to raise a first fund. It is hard to set up a business. So if you create an extra layer of requirement before carry can be achieved, it risks demotivating the management team – especially the younger managers. They might not stick around.

"This is a big risk, as the questions we get most often from private capital investors tend to be around the experience of the management team and whether there will be consistency of personnel. Adding extra hurdles for management could be seen as a red flag by the traditional private equity players."

To this point, Nathalia highlighted the importance of keeping a close eye on impact targets to ensure they are achievable. "We set tailored KPIs for each type of investment and work with third parties to ensure the right balance of ambition and achievability over time.

"For example, last year we launched a fund dedicated to financing small assets that contribute to the energy transition. When we started to develop the impact assessment methodology, I was very cautious to ensure that the investment team would consider scenario evolutions rather than linear reductions, so they would not be penalised at a later stage when CO_2 emissions have already been significantly reduced so further reductions seem small by comparison. It's important to recognise this context. We therefore use a methodology that is pragmatic and realistic enough so the investment team has the right level of incentive."

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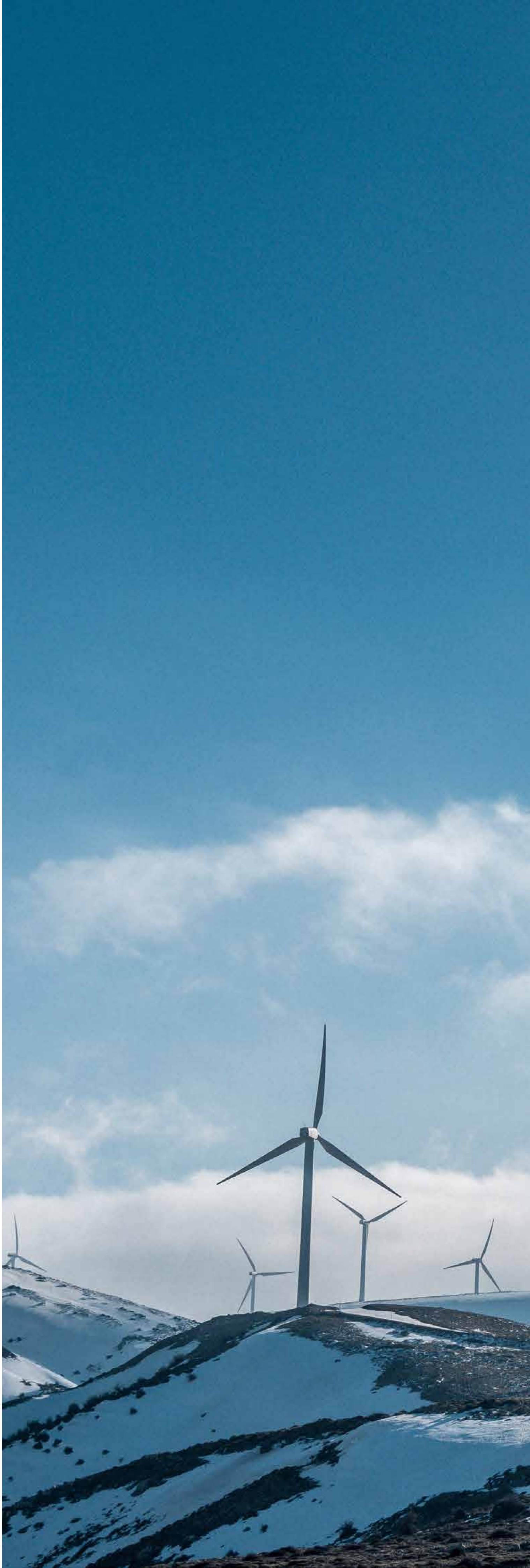


Measuring impact

Incentivising impact relies on the ability to measure impact, so what is it that gets measured and how? The roundtable group's discussion made clear the vast spectrum of ways to qualify and quantify impact attainment depending on the fund's specific focus, including varied levels of granularity.

What to measure?

Tom Powell has not reached the measurement stage with Amthe Capital as there has yet to be direct investment, but the fund does have a clear measurement framework that will involve working with NGOs on the ground in Africa, using qualified local representatives to assess the investment recipients and gather data.

"Working with University of Reading, we've given specialist software to operatives in the field to be able to report back on cattle types, the state of fertility, gestation cycles, et cetera. Our approach requires physical inspection at farmyard level, but it is then easy to assess the immediate impacts of yield and fertility increases. From these factors, you can infer higher production indicating higher consumption – unless there are reports of wastage."

Discussing additional metrics that Amthe Capital will be able to harness, Tom continued: "At a national consumption level in Rwanda, you can see that at the moment only 17% of locally produced milk goes into a formal market. We'd expect to see our per cow yield increase, helping to grow this percentage. Plus, supermarkets, suppliers and processors all keep inventories. We can use a range of tangible metrics to establish that there has been higher processing, more consumption, and also an increase in quality – for example through less sugar being used, less wastage, a growing cheese industry, and so on. The framework we've developed considers all of these metrics."

In sharing some of Tikehau's impact metrics, Nathalia Millan highlighted the different measurements used depending on the exact strategy of the fund. "For our decarbonsation fund, our core impact measurement is avoided CO2 emissions. For our new regenerative agriculture fund, however, it's a bit more complex. The impact is multidimensional, so we have measurements relating to biodiversity, carbon, water, plus social impacts around the quality of life of the farmers, their income, and also the nutritional content of products. We set specific KPIs for each different fund."

"What works for a cattle feed production company is very different to what works for a yoghurt processing facility."

Tom also flagged the difference between impact metrics at fund level and portfolio company level, and the importance of tailoring the success criteria for each portfolio company. "What works for a cattle feed production company is very different to what works for a yoghurt processing facility," he explained.

Getting to the bottom of the pyramid

Justin queried whether taking KPIs down to portfolio company level is sufficient. "Across a number of the impact funds we're working with, LPs are questioning whether portfolio company level data is able to demonstrate real impact. In some cases, the theory of change and impact thesis require going further and generating some form of data from 'beneficiaries' – whether that means employees or customers of the portfolio company. This is particularly relevant in an emerging market context."

"There's a line to follow to see where the capital goes and get to the bottom of the pyramid to work out who is actually in receipt of the capital and how are they implementing their goals," said Tom.

"Having an in-country team and network is vital," he continued, "as well as very clear metrics to benchmark against. And making those benchmarks achievable and simple to report on. In my case: what is your increase in milk yields? Have you seen a rise in the number of dollars you're receiving on a monthly basis for the milk you are selling? Next level up: are you selling more in supermarkets? In other words, are you still selling at the farm gates or are you reaching the urban markets?"

Tom noted that there is a myriad of data points at individual cow level, but "that's less relevant really. It offers some great feel-good stories, and you can get brilliant testimonials from people who have been recipients of the investment, but when it comes to measuring true impact, it's about analysing the higher-level and later-stage data."

Discussing how Restitution measures impact, Katherine pointed out that following the investment all the way to the end user is not always required or, indeed, desired. "We're driven by the national priorities of the country in question. So we could end up with an education fund or, to give you an example of one government we're currently working with: their goal is to de-mine the country, so we started working with one of the world's biggest de-mining organisations and are in the process of building a fund around them.

"Our impact is looking at the positive outcomes the country was aiming for and the support we've provided to help get them from A to B. Don't forget – what we're dealing with is their assets, their claims. We can't tell a country they must do this or that. It's a symbiotic relationship and there's an important balance to be struck."

"LPs are questioning whether portfolio company level data is able to demonstrate real impact. In some cases, the theory of change and impact thesis require going further."

Lost in translation

Nathalia observed, to the amused agreement of the group, that investors are often very keen to see impact being demonstrated, but they tend not to have precise demands on what KPIs they're looking for. "Apart from very specialised LPs, such as environmentally-driven asset owners, LPs appear to be using a 'test-and-learn' approach. They're learning from what they see in the market and are very open to understand what we have been developing. So, we as asset managers have an important role in presenting what we've achieved to contribute to market practice."

Adding to this complexity, on the other side of things there's the fact that portfolio companies often don't speak the same impact 'language'. "We're applying the impact label rather than them telling us," observed Tom. "They have their objectives, but we look at these objectives and define them as impacts."

Innovest's Justin Sykes concurred: "Language is really important in this space. The investor often uses different language compared to the investee, and that creates challenges in terms of ticking particular boxes. An investor will want to see the company's theory of change, KPIs and metrics. All of this activity may well be taking place, but it's not labelled the same way so therefore doesn't satisfy the tight parameters of the investor."

Justin shared the example of a fund-of-funds manager that Innovest is currently working with, which is investing in 12 to 15 underlying impact funds. "A number of those funds are pure sustainability funds, investing into the energy transition or green assets, but historically they've never branded themselves as impact and don't have a clearly defined theory of change or overarching impact strategy. This is really challenging because you'll be doing due diligence on the underlying manager to determine whether it fits with the fund of funds' impact strategy, but none of the required terminology is there and you have to interpret whether, in fact, they are doing all of the right things but calling it something else. A logic framework rather than a theory of change, for example. By interviewing the team, you see that they are actually doing what you require. Not only is this a challenge, it creates inertia in the system as well."

"The investor often uses different language compared to the investee, and that creates challenges in terms of ticking particular boxes."

The challenge of sustainability regulation

Speaking of creating inertia in the system, no impact investing roundtable would be complete without talk of sustainability regulation. Of particular relevance to this group is the EU's Sustainable Finance Disclosure Regulation (SFDR), which is well underway in its implementation, with the SFDR Regulatory Technical Standards (RTS) having taken effect on 1 January 2023.

SFDR hoops and hurdles

Nathalia Millan commented that, for Tikehau Capital, new doors have opened with their move into impact funds because "European investors are very keen to see SFDR 'Article 9' funds." Article 9 funds being those with sustainable investment as their primary objective. But while this is an opportunity in one sense, it "also comes with regulatory constraints in terms of reporting and making sure the team is up to date on the different standards when looking at investment opportunities."

Avardi Partners' Guillaume Leredde commented: "What I'm hearing from everyone in the impact investing space is that the main challenge is proving you're an impact investor. It's actually quite ironic. The focus should be on making the right investments, developing the right technologies and so on, but so much time is spent trying to evidence that you're doing the right thing. Is the regulation too strict? Are people too afraid of greenwashing?"

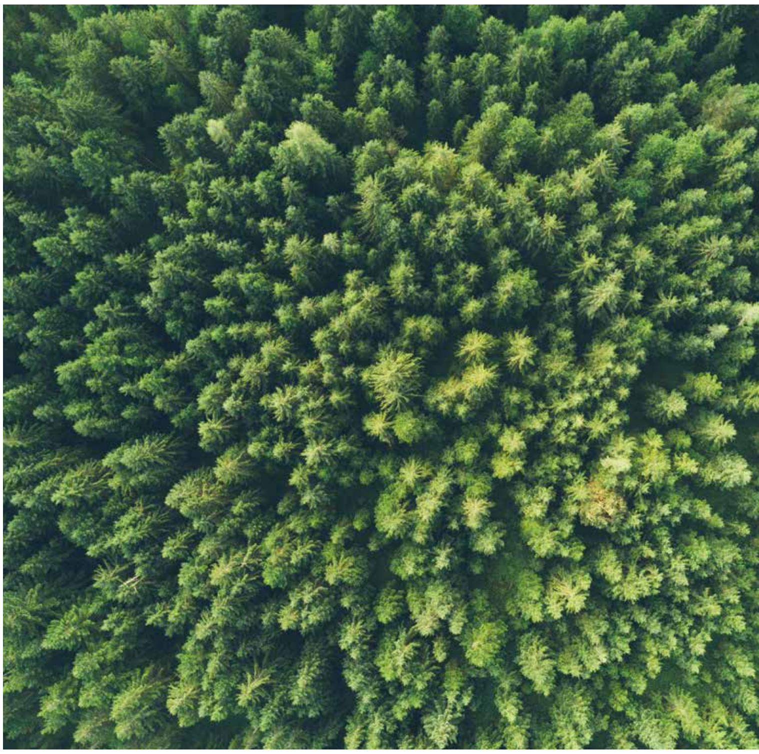
Amthe Capital's Tom Powell agreed, noting a growing hesitancy among investors towards ESG-labelled funds because of SFDR and the challenge of achieving the desired Article 9 status. "Unless you're able to show an intentional and direct impact, investors are much more wary these days. Choosing off-the-shelf, ESG-screened items doesn't cut it and may come back to bite further down the line.

"Meanwhile at Amthe, as well as trying to do the right thing, make the right decisions, invest in the right companies et cetera, we're having to jump through hoops to show what we have achieved and what our impacts will look like – which is both expensive and time-consuming."

Speaking about green financing, Guillaume described a similar situation: "When an ESG fund is trying to put financing in place – be they classified as Article 8 or Article 9 – it can be quite difficult depending on where they are in their ESG strategy implementation. Some funds have ESG strategies that are not well defined, so we usually advise these clients not to go the green financing route, simply because they would not meet the bank requirements. Banks need to avoid greenwashing at all costs, so they're very strict.

"Where we have fund managers dedicated to sustainable investing, those managers can receive green financing as it can be applied directly to, say, an energy transition project. Such an initiative can get quite a positive response from banks, offering the best margins, but the process is still very complicated.

"Even for the greenest of green funds, putting in place a green loan framework that will be approved by a bank is a real challenge. We did this earlier this year and it took three months and was quite an intense process. We managed to do it, but it's not something that has been done a lot in the fund finance market to date. Hopefully as more and more people access green financing, it will become more mainstream," Guillaume concluded.



"Regulation is designed to move the market and lift the lowest common denominator," Innovest's Justin Sykes observed, "but the unintended consequence is that well-intentioned managers are being caught by regulation. And it's purely an administrative, bureaucratic burden; an additional cost to do business. The climate impact manager of yesterday now needs to become SFDR Article 9 compliant.

"While I understand the overarching objective to prevent greenwashing, if you're a small- or medium-sized manager who has been in this space already for 10 or 20 years and is doing good things, it's just a headache."

Justin proceeded to highlight the true scale of the problem presented by the regulation: the challenge of getting all of the underlying parties on board. "For example, a fund of funds investing into emerging markets. Does every single Asian or African or Latin American fund manager know about SFDR? Are they fully prepped and able to effectively communicate reporting obligations down to their portfolio companies?

"We have close contact with an EU-based impact fund of funds manager who is investing into African impact funds. SFDR is a big problem for them because they need to educate every single one of their managers within the pipeline on what SFDR is, how the classification works, what needs to be disclosed, the reporting regime, what PAIs are, and so on. And until they figure all of that out, they will have significant challenges in deploying their capital.

"The likes of SFDR represent a regulatory tidal wave hitting everywhere around the world. In our practical experience, it's actually slowing down the flow of capital, and that's a major issue when we have the existential crisis right now of climate change, which requires we get more capital into the market fast."

"The likes of SFDR represent a regulatory tidal wave hitting everywhere around the world. In our practical experience, it's actually slowing down the flow of capital."

Finding alternative paths

Faced with the onerous requirements of SFDR, the conundrum now facing fund managers is whether or not to bother. "We work with a London-based private equity manager focused on investing in the energy transition," Justin shared. "Their first two funds were raised entirely from UK and US investors, but for their third fund they have attracted their first potential EU LP. However, the EU investor has said the fund needs to be Article 9 otherwise there isn't any point them even considering it. So now this manager is conducting a cost-benefit analysis of becoming Article 9 compliant, assessing what it would take in terms of time and effort, and what the required level of investment from the LP would need to be provide sufficient management fees to do all of the work required to meet the regulations."

So what's the solution? Continuing to do good but choosing not to qualify as an impact fund? Clearly this isn't an option if hoping to attract EU-based investment. Concluding his example of the energy transition fund, Justin noted that the manager might decide that EU capital isn't worth their while; they may opt to focus only on UK and US LPs again. "We see similar conversations happening across multiple fund managers right now," he added.

Tom commented that, if you structure as a Jersey fund and only raise capital from non-EU investors, there is no problem at present. "We are seeing managers increasingly moving to jurisdictions like Jersey so they can raise money and do good while avoiding unnecessary regulatory complications."

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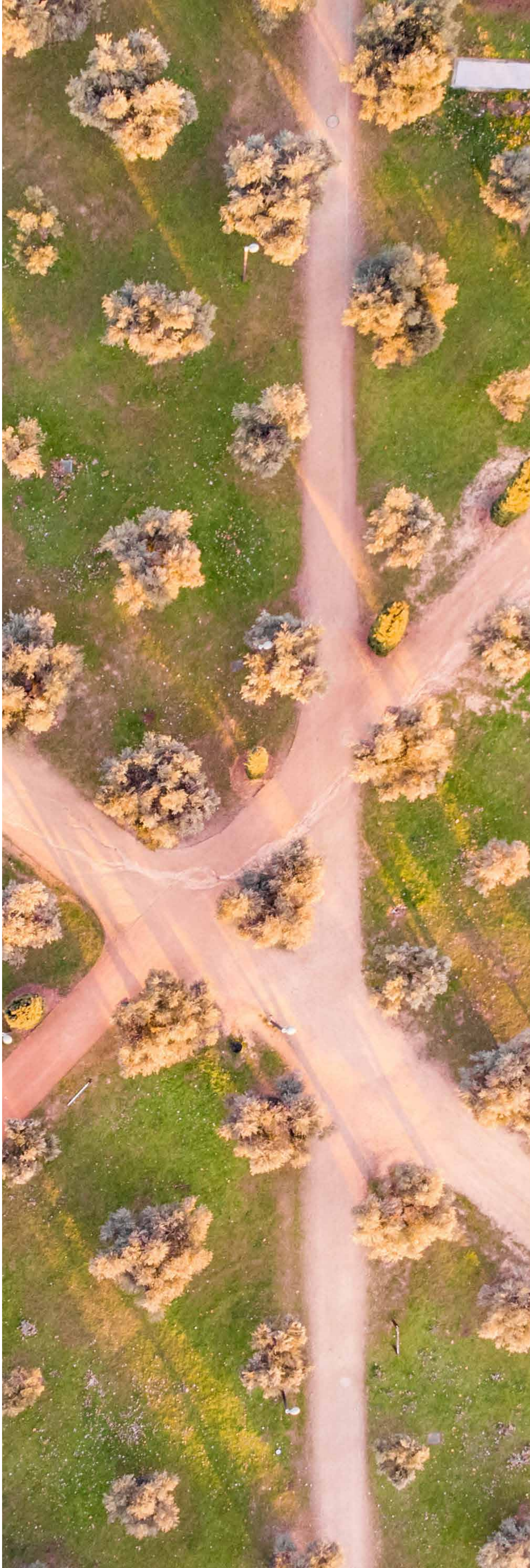


Impact investing: a work in progress

Throughout the roundtable discussion, each participant at one point or another caveated that they don't have all the answers and that there's still considerable work to be done to bring impact investing into the mainstream.

Everyone's still learning

Nathalia Millan of Tikehau Capital commented that, while the firm first ventured into impact in 2018, their impact committee was only established in 2022. It was created to address the need for balanced, collective decision-making at group level. She also noted that Tikehau's first impact fund, the T2 Energy Transition Fund, could be considered as an impact incubator as it allowed them to "test the impact approach and start putting in place some initiatives to test the intentionality of investments."

Nathalia stressed the fact that Tikehau is still on a learning journey: "We are very humble and conscious that our impact measurement is not perfect – far from it. Especially in relation to avoided carbon emissions because in theory you could demonstrate whatever you want, so we're working hard to ensure we have an adequate, third-party-verified baseline. But I believe we are all learning as we go."

She also shared that Tikehau's new fund focused on the European resilience and sustainable transition has been a "real challenge" owing to the fact there's no common KPI at fund level – the KPIs fully depend on each portfolio company and their strategy.

> *"We are very humble and conscious that our impact measurement is not perfect —far from it. But I believe we are all learning as we go."*

"It took us six months to work out the investment strategy," revealed Nathalia. "We wanted to support the European resilience and sustainable transition but this in itself isn't 'impact', so we needed to understand the social and environmental objectives we wished to address within the European resilience strategy. We identified a long list of possible investible segments and worked with a consultant to define a Tikehau nomenclature that includes around ten target macro-categories and considers existing standards such as the EU Taxonomy. We like to call this framework our 'impact investing playground', with impact areas that contribute both to resilience and to a social or environmental goal – such as reducing waste, improving education or enhancing gender diversity."

Guillaume Leredde concurred that there's "still a lot to learn", but that "it's getting there." He noted that Avardi Partners is "seeing more and more clients dedicated to this type of investing" and that "they will set a precedent for others. It's a transition phase. I think within the next five years, impact investing will be much more mainstream."

Amthe Capital's Tom Powell commented that "a lot of investors still don't understand that impact isn't the same as philanthropy, and that we're looking to make a return." He asserted that what's required is "an evolution of the whole investment universe, particularly for the ultimate asset owners, the pension funds et cetera. They should be including impact as a core metric for all their investments."

The problem with SMEs

In discussing the difficulties surrounding Tikehau's European resilience fund, Nathalia also noted the aforementioned problem of trying to invest in companies at differing levels of maturity, where "it can be difficult to draw the line regarding when to say yes or no to investing because they don't have the internal capabilities to feed the impact measurement machine."

The roundtable discussion made clear that this point is a major hurdle in the impact investing space, as these smaller, less mature businesses are often the ones with the greatest potential for impact. "One of the biggest problems we have with financing SMEs," stated Tom, "is that a lot of them are so badly organised they're impossible to invest in. You might have great people with a great idea, but they either can't articulate it or set it up in such a way that enables a private equity stake or debt arrangement."

Justin Sykes agreed, noting that Innovest is witnessing the same dichotomy. "Particularly in an emerging market context," he observed, "the challenge is identifying underlying SMEs that understand impact, have an impact framework and measurement system in place and can gather the necessary data. Otherwise, there's a real risk that the fund manager is claiming impact but, although the impact is there, the plumbing required for reporting meaningful, transparent, disaggregated impact data is not."

Justin queried what the solution is to this, suggesting the need for "some sort of on-the-ground business support facility, providing an on-ramp for companies to be eligible for funds."

Harking back to the earlier discussion around partnering with portfolio companies to improve their set-up and steer clear of divestment, Tom concurred there "is a need to go into the structure of SMEs and put them into a system where they can grow, as a lot of them are hamstrung by their own inability to source talent or identify the gaps where talent needs to be brought in."

Of course, this is easier said than done – especially when you throw complex regulatory requirements into the mix.

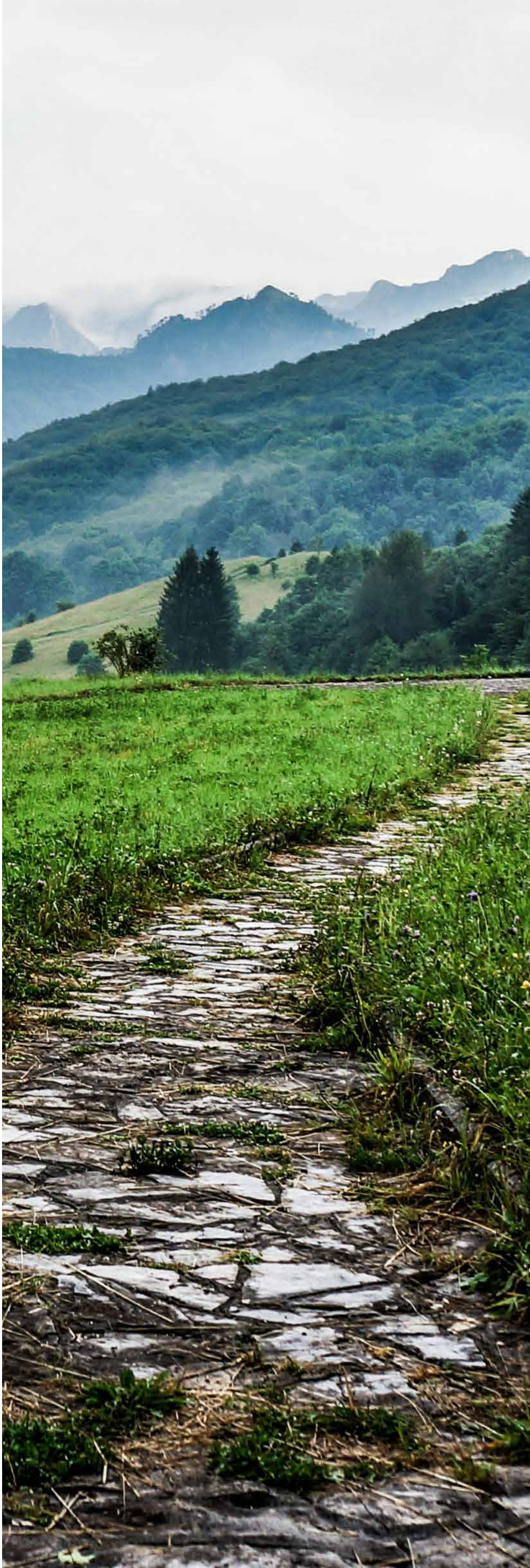
The next generation

With all of the above being said, consensus around the table was still that things are heading in the right direction, and that impact investing will only continue to grow – well beyond that trillion-dollar milestone.

More than merely a passing trend, impact is being driven by a "generational shift" over and above any other market or regulatory factors. In the context of incentivisation, Justin noted that a company's purpose has become one of the leading recruitment factors, while Guillaume asserted that impact-related reward is important for attracting the next generation of talent.

"I do think impact is more and more important for younger generation of investment managers," remarked Guillaume. "The next generation want a sense of purpose. Just trying to get the most out of a company and sell it for as high a value as possible is not sufficient now. Millennials and Gen-Z aren't merely interested in financial gain, they want to make sure they making a positive impact." And if our roundtable session made one thing clear, it's that where there's a will there's a way.

"The next generation want a sense of purpose. Just trying to get the most out of a company and sell it for as high a value as possible is not sufficient now."



About our participants

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Emmanuelle started her career at McKinsey & Co as an analyst. After her MBA at Columbia Business School, she joined Morgan Stanley, in corporate finance, before moving to join Bank of America's Corporate Finance team. She then became an in-house M&A / corporate development manager. After several years in corporate roles, Emmanuelle went on to specialise in wealth management, advising mostly private equity senior partners and entrepreneurs, first at Barclays and later at Edmond de Rothschild. Since joining IQ-EQ in 2016, Emmanuelle's focus has been on business development, working closely with private equity fund managers and family holding companies on their administration needs.

Justin Sykes
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Justin is an impact investment specialist with over 20 years' experience in supporting the design and deployment of private capital to create better opportunities for vulnerable communities. These investments have positively impacted hundreds of thousands of lives across a diverse range of countries globally, with an emphasis on emerging markets. His wide-spanning career history has included working for a range of impact asset allocators including international non-profits, the UN and a major private foundation. He serves as a board member and adviser to a number of microfinance institutions and international charities engaged in supporting the livelihoods of low-income communities. He is also a non-executive director of the Guernsey-domiciled Fund 1 of Blue Earth Capital, backed by Partners Group.

Guillaume Leredde
Director, Avardi Partners

Guillaume has more than 14 years of experience in leveraged and corporate finance, structuring and delivering over 40 transactions in Europe. Before joining Avardi, he worked at Deloitte in the debt and capital advisory team focusing on transactions involving direct lenders. Prior to that, he worked at Barclays, Moody's and GE Capital in their respective leveraged finance teams. Guillaume holds a Master of Science in Telecom and a Master in Corporate Finance from EM Lyon business school in France.

Nathalia Millan
Head of ESG for Private Equity, Tikehau Capital

Nathalia joined global alternative asset management group Tikehau Capital in 2020 to reinforce the development of the Group's sustainable investing strategy. She now serves as the Head of ESG for Private Equity and her role is to support the definition and deployment of the impact and ESG strategy for private equity funds and investments. Nathalia previously worked for more than three years as a strategy and sustainability consultant for large European asset managers at INDEFI. In this context, she has developed impact measurement methodologies and participated in the launch of private equity and infrastructure funds. She has also worked at La Banque Postale where she monitored Carbon Fund projects that aimed to finance GHG emission reduction projects. Nathalia began her career in 2013 in Colombia, at the European Union Delegation to Colombia and at Oxfam.

Katherine Mulhern

CEO, Restitution

Katherine is a senior lawyer with significant experience in transparency, accountability, governance and anti-bribery and anti-corruption. A former investigator for an African Truth and Reconciliation Commission (TRC), Katherine has also been a senior law firm partner in private practice, the CEO of three leading development organisations based in West Africa, the UK and the United States, and a consultant for sovereign governments, including donor governments. In her role as Restitution's CEO and as a consultant, Katherine has provided legal advice and support to emerging democratic governments (including Iraq, Afghanistan, Zimbabwe, The Gambia, Kenya and others) on a variety of technical legal issues, including in relation to anti-bribery and anti-corruption.

Tom Powell

Founder and MD, Amthe Capital

Tom founded Amthe Capital in 2019 to identify sustainable investments in the agricultural space. Working alongside Jersey Overseas Aid and the Royal Jersey Agricultural and Horticultural Society, he seeks "for profit" investments that complement their grant and aid work. Tom has a background in agriculture and over 20 years of front office trading and risk management experience from Société Générale, Marex Spectron, Jefferies Bache, and subsequently in commodity trading hedge funds. Tom is based in Jersey, UK, where alongside investment director roles he chairs the Jersey Funds Association subcommittee on ESG and is a member of the Jersey Sustainable Finance Steering Committee. In 2022, Tom represented the commercial side of Jersey at the Commonwealth Heads of Government Meeting in Kigali, Rwanda.

About IQ-EQ

IQ-EQ is a leading investor services group that brings together a rare combination of global technical expertise and deep understanding of client needs.

With over 4,300 people across 24 jurisdictions, we have the know-how and the 'know you' to provide a comprehensive range of administration, compliance, asset and advisory services to fund managers, multinational companies, private clients and family offices operating worldwide. We have more than $750 billion in assets under administration and work with 11 of the world's top 15 private equity firms.

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We are proud to offer the most complete service offering to alternative fund managers globally.

About Innovest

Innovest Advisory is an impact investment advisory firm helping our clients to become more intentional about impact and embed impact into their processes.

We help our clients to achieve targeted social and environmental outcomes, bringing extensive experience from the development, climate change and broader environmental sectors together with capital markets into the evolving impact investment field.

We work with fund managers, asset owners, companies, international organisations and non-profits across a broad range of sectors including but not limited to infrastructure, financial inclusion, renewable energy, agribusiness, climate change, job creation and women's economic empowerment.

Find out more
iqeq.com/funds/impact-fund-services

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