



Can Investors Save the Planet While Making a Profit?

Sustainability is fast becoming a core investment focus. Here's what the industry can learn from the most successful climate impact funds.

Globally, climate change has dominated the public space in the past couple of years. A vast increase in **climate change articles in the last two years**, emerging 'climate idols' such as Greta Thunberg and climate-related pop culture (e.g., *flygskam* being **FT's Word of 2019**) have been just some of the indicators of this megatrend.

This has propped up a strong investor demand. To wit, 84 percent of millennials **invest with a focus on environmental, social and governance (ESG) impact** as their central goal as compared to less than 50 percent for baby boomers. Climate is now regarded as the **top theme in impact investing**. Given that an estimated US\$68 trillion will be passed down from baby boomers over the next 30 years, with up to 80 percent of investment goals being reconsidered in the process, a **significant flow of investment towards impact** – specifically, climate change – is expected.

Similarly, the supply side has also seen growth, although still mainly in 'pockets' and with limited regulation around it. There has been an emergence of green bonds, green-project finance and ESG-agnostic investments in public assets. Large PE/VC funds (LeapFrog, KKR's Global Impact Fund, TPG's Rise Fund, Bain Capital's Double Impact to name a few) have also come to the forefront.

The main obstacle: Inconclusive evidence about financial returns

Early studies examining the financial impact of climate change investment have been at best inconclusive. For example, a 2019 survey by the Global Impact Investing Network (GIIN) indicated that impact funds seeking market-rate performance realised returns greater than 16 percent since inception. Yet, according to another study GIIN did with Cambridge Associates, the returns of approximately 80 impact investment funds lagged their emerging market PE/VC index by 2-6 percent across any given time period. J.P. Morgan analysts found that global pure play climate change funds underperformed by 5 percent annually for the past 10 years.

However, we can observe a trend towards investors becoming more confident in the positive financial impact of climate change investment. This trend is rooted in investors' perceptions that ESG investing pays off by **boosting returns and increasing alpha**. This is underlined by four main economic value-add factors: revenue upside (driven by consumers' eco-friendly behaviour), cost savings (reduced resource use and increased process efficiency), improved operational, regulatory and reputational risk mitigation, and growth in the investment market enabling attractive exits.

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A good indication of growing investor confidence in impact and climate change investing has been the ability of individual ESG funds to progress to round 2 fundraising. For example, TPG's Rise Fund II is targeting US\$2.5 billion (with US\$1.7 billion secured as of late 2019) and LeapFrog is closing its third fund at US\$700 million (with US\$100 million oversubscribed assets under management).

Key attributes of successful impact and climate-focused investment funds

Our proprietary analyses using more than 50 impact investment funds globally (from various databases such as PitchBook, ImpactAssets, Crunchbase and fund websites) show key emerging characteristics to be considered for climate change funds:

- Average assets under management of around US\$200 million (with actual values ranging from 3 million to 1.5 billion), with an average fund manager tenure of just over 13 years
- Most funds invest at seed to series C stages and most are headquartered in the United States or Canada, although investees are mostly in emerging countries
- The UN SDG tackled by the largest number of funds in our sample is "**Decent Work & Economic Growth**", followed by "**Climate Action**"

Most impact funds have over 25 investors, with two distinct structures observed. The first comprises smaller funds with foundations and family offices as the main types of investors. The second one includes larger fund managers (TPG, LeapFrog, North Sky Capital, SEAF, DBL Partners, etc.) with a more varied investor base including international finance, pension funds, insurance and other asset managers. The overall investor universe still appears to be concentrated, with the same limited partners (LPs) repeated among many general partners (GPs). For example, ImpactAssets is a facilitator of direct impact investing within donor-advised funds, and is the most common LP representing 568 impact investment positions.

Three successful investment theses

Three key investment theses – or rationales to guide decision making – prevail within established, successful impact-focused funds: targeted, rating and monetisation investment frameworks.

Targeted funds like LeapFrog and Bamboo Capital Partners base their thesis on global needs and gaps in the market. They leverage external evidence and research to connect their theories of change to the ultimate impact they seek. Most often such businesses assess traditional and impact-specific KPIs from their portfolio companies on a quarterly

basis.

Rating framework funds like PG Impact Investments and KKR's Global Impact base their thesis on logical models that link a target company's product/services to ESG-related outcomes. A core feature of each thesis is understanding the evidence that links outputs to outcomes. Impact assessment is based on the rating of expected ESG outcomes using pre-set proprietary frameworks. The fund monitors impact throughout the ownership period by using three to five metrics agreed upon with each portfolio company, and often reported annually.

Last but not least, monetisation funds (such as TPG's Rise fund) focus on financial objectives, accompanied by a specific impact thesis for each investment. Their approach is heavily grounded in academic research. Each impact pathway articulated in the investment thesis is supported by a rigorous study that translate outputs to (monetary) outcomes. Impact assessment is based on business indicators related to the targeted ESG outcomes, combined with an economic valuation of those outcomes, typically reported on an annual basis.

Best practices for determining climate-focused investment thesis

Well-run impact funds are designed with a clear ESG goal or theme in mind. Further, they specify stage and geography in order to pin down the risk profile of the fund and facilitate fundraising. They are not committed only to impact, but also to financial returns. A strong acknowledgement of the importance of financial success remains a key performance factor common to 95 percent or more of the funds we examined.

With this in mind, PEs should follow three steps to set up a successful investment thesis. First, identify attractive 'spaces to play' by applying a consistent framework (around growth, overall potential, intensity of competition and opportunity for impact). Second, restrict the list of 'spaces to play' to the fund's areas of strength and capabilities. Third, identify specific business models which can serve as examples for potential archetypical targets.

Best practices in operationalising climate change investment

The most successful impact funds we studied (e.g. TPG's Rise, Leapfrog) embed impact actions along the fund's full value chain, beyond deal sourcing. This avoids 'greenwashing', maximises financial and impact potential, ensures consistency and establishes reputation in the space. This in turn enables fundraising, target identification and exit opportunities.

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In addition to identifying and targeting investors especially interested in the area, larger funds have the opportunity to tailor investment allocation. This can be done through fund structures or terms ensuring that LPs concerned with particular ESG issues are directed to investments aligned with their views (when scale of fund achieved).

Further, such funds should incorporate climate-focused ESG criteria into target identification, investment analysis and decision-making processes. They can do this by evaluating the historical impact and future potential of companies via proprietary frameworks (tailored to their investment theses) or third-party rating agencies (to benchmark ESG performance at the point of acquisition).

Successful climate funds would not stop there. They would proceed to incorporate ESG into ownership policies and work together with portfolio companies to guide effective implementation of ESG goals. They would also facilitate ESG learning across portfolio companies where appropriate. They would seek appropriate disclosure on progress, initiatives and impact achieved (tracking two or three ESG-related KPIs in addition to financial and operational ones).

Lastly, they would proactively identify climate-positive strategic or PE partners for exit opportunities and institute governance structures to ensure lasting impact after the change of ownership.

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