Impact Investing Comes Into Its Own

By Claudia Zeisberger , INSEAD Senior Affiliate Professor of Decision Sciences and Entrepreneurship and Family Enterprise

A discussion with Kevin Lu, Chairman for Asia at Partners Group and Distinguished Fellow at INSEAD's GPEI.

In 2010, INSEAD's Global Private Equity Initiative (GPEI) started to explore the nascent trend of responsible investing. In 2014, it published its first **report** on environmental, social and governance (ESG) factors within the private equity (PE) context. Four years hence, the industry has evolved significantly.

The increasing demand for public accountability and transparency around environmental and social issues has led limited partners (LPs) to push for increased ESG awareness. Many of the LP requirements are formalised in their internal guidelines and form part of their fiduciary duties. For United States public pension plans – the largest allocators to PE – and other government-affiliated LPs, direct oversight from government institutions and additional regulatory requirements lead to additional emphasis on ESG. As LP beneficiaries are often large groups of citizens, there is strong motivation for institutional investors to improve sustainable practices and increase accountability.

In our recently published book ***Mastering Private Equity***, my co-authors and I dedicated a chapter to responsible investment because we strongly believe that PE can serve as a force for good. PE firms are well positioned to implement responsible investment strategies and promote sustainable business practices due to their active ownership and corporate governance model. In the past decades, the PE industry has created considerable wealth and employment in the advanced economies. As it expands its reach into emerging markets, its potential impact on the economic, social and ecological environment of communities might be even greater.

Although there is no commonly accepted definition of responsible investment, we consider it a mandate to go beyond a narrow target of financial returns and incorporate a commitment to do good or, at a minimum, be a responsible guardian of the portfolio company and its environs.

The ways in which PE funds can implement responsible investment strategies range widely: from negative screening to proactive ESG management strategies to impact investment funds. The framework below distinguishes five main approaches to investment based on the importance assigned to social returns.

The mainstreaming of impact investing

In the past couple of years, a number of the biggest and best-known GPs announced impact strategies (e.g. TPG’s Rise Fund, BainCapital’s Double Impact and KKR’s Global Impact). To understand this recent trend of responsible investing from a GP’s point of view, I had a conversation with

Kevin Lu, one of the GPEI’s Distinguished Fellows, and the Chairman for Asia at Partners Group. Lu was closely involved in the recent launch of the group’s first impact investment vehicle called PG LIFE and chairs its Impact Committee.

Lu mentioned that as with many product innovations in PE, the recent trend of responsible investing is driven by client demand. A diverse set of LPs, from sovereign wealth funds and public pensions to high-net-worth individuals and multi-family offices, recognise that it is not necessary to trade off return for positive impact. Accordingly, there is increased demand for products that can deliver this dual return at scale. Within the private markets industry, he foresees outsized growth in the mid-term mainly due to a tighter regulatory environment, increased cooperation on the political front, and a more socially and environmentally conscious millennial generation, set to inherit an estimated US$40 trillion in the next 40 years.

However, he adds that this mainstreaming of impact integration is not totally new. It is the culmination of over ten years of increasing LP focus on the area. Identifying, measuring and reporting the positive impact of investments is a natural extension of long-established responsible investment practices that drive companies to systematically improve their ESG performance.

Lu warns that as the strategy becomes more mainstream, many PE firms will be tempted to develop similar strategies to meet fast-growing client demand. That said, many will be apprehensive about positioning themselves in this space if they don’t have the appropriate responsible investing or impact credentials. The brand and reputational risks of following this trend without a credible offering would be too high.

Impact investing requires highly skilled professionals and institutional-quality platforms to deliver on both financial and social/environmental impact. Lu adds that there will be a clear differentiation between those whose intentions are oriented toward the merits of impact investing in the long run, and those who might be leveraging the industry’s tailwind for short-term gains.

The differentiators will mainly be the ability to deliver the social/environmental impact and financial returns, the contribution to and consolidation of the broader industry’s best practices and the ability to provide transparency to clients on their impact.

Benchmarks for international impact

Partners Group’s PG LIFE will address global social and environmental challenges by investing in line with the United Nations’ Sustainable Development Goals (SDGs), a set of universally relevant impact targets. While other funds are primarily PE funds, PG LIFE is a blended private markets fund, which will also include allocations to real assets like infrastructure and real estate. Lu highlights that global tilt and multi-asset fund composition provide diversification, which enables better risk management.

PG LIFE benefits from two internal investment governance bodies, both of which need to approve every investment. PG’s Global Investment Committee assesses investments in terms of their ability to deliver attractive risk-adjusted financial returns, while the PG LIFE Impact Committee focuses on assessing their ability to deliver positive social or environmental impact.

Lu does not see a contradiction between a company's commercial attractiveness to a private markets investor and its potential to generate positive social and environmental impact. In fact, he would argue that sustainability-minded businesses can be better positioned for long-term value creation. As an example, he explained that analysis of past PG investments that aligned with the PG LIFE strategy established a track record with "normal" private markets returns, specifically a blended gross IRR of 17.9 percent. All of these track-record investments underwent – just as all PG LIFE investments – Partners Group's rigorous Global Investment Committee process.

Measuring the impact of ESG initiatives is one of the biggest challenges to overcome. When Lu was asked how PG LIFE measures impact, he mentioned that three to five impact metrics that best capture the target's potential are identified during due diligence. These metrics will be closely tied to the target's core business and projected business plan throughout the ownership period.

My conversation with Kevin Lu made it clear that the institutionalisation of responsible investment’s best practices is increasingly aligning the fiduciary duty of GPs with the ESG interests of the LP community. With this expansion of the PE mandate beyond financial returns, regulation and improved benchmarking tools continue to emerge that will drive development and enforcement, allowing the PE community to continue discovering which practices deliver social impact and which do not.

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