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EXPERT OPINION

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IMPACT INVESTING: GETTING A HANDLE ON IT - PART 1 -

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Introduction

Over the past two years, countless asset management companies have launched impact funds. The search for impact has undoubtedly become the new frontier[1] of responsible investment. This dynamic is part of a growing demand from investors to better understand the concrete externalities of their investments. It is also marked by the success of new methodological frameworks, led by the Sustainable Development Goals[2]. The numerous works on the definition and methodological harmonization of impact investing (Impact Management Project, Operating Principles for Impact Management, GIIN reports, FIR-France Invest report, etc.) highlight two major trends.

On the one hand, impact investing is no longer confined to a niche in private equity or philanthropy, as it was in the 1980s. Indeed, the new definitions now attempt to cover many asset classes. On the other hand, the constitution of common standards makes it possible to create firewalls for impact washing practices, resulting from the free interpretation and more or less robust practices of each player, in the face of the methodological vagueness that has reigned for several years.

The objective of this expert opinion is to provide four insights to better understand what impact investing means in practice.

What is Impact Investing?

"Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return."
Global Impact Investing Network (GIIN)

September, 2021

1 Putting the impact in context

The "world of impact" can take many forms. Indeed, it can cover projects related to the social economy, to public policies or to the development of emerging countries, or it can be part of the intention to measure a contribution to the Sustainable Development Goals. Impact also covers the actions of several players. Who is the source of impact in an investment chain: the companies invested in, the financed project holders, the investors?

Some clarity is required here.

The impact comes from the investment

The impact is that of the assets invested/financed. The investor's role represents a contributor or facilitator, not a direct source of impact. They can however communicate on the impact of their investments or possibly take ownership of it, if this is justified and measured. Regulators confirm this position by asking managers to give priority to communications on the impact of selected companies.

The investor's role

Even if the final impact is that of the investments, the impact investor has a real role to play. Investing in positive impact companies is a necessary but not sufficient condition for impact investing. For example, communicating on the avoided emissions linked to the solutions proposed by the companies in one's portfolio in one's annual report does not systematically make the investor an impact investor.

In fact, the investor must integrate impact into each stage of the investment process, beyond measuring impact after investing. The main characteristics that an impact investment must meet have been developed by finance professionals and piloted by the FIR (French Sustainable Investment Forum – French SIF) and France Invest[3]. Nine criteria have been established and are presented below.

Intentionality	Additionality	Measure
➔ Search *ex ante* for a double objective: financial performance and response to a sustainable development issue	➔ Increase the net positive impact generated by funded activities	➔ Evaluate the potential externalities of investments with regard to the impact objectives set
1. Clearly defined **impact strategy**	**4.** Integrated **additionality** approach for most of the assets	**7.** Use of **impact measurement** indicators
2. Formalized impact approach throughout the investment cycle	**5. Long-term** investment horizon	**8.** Development of solid impact **reporting** with integrity and transparency
3. Appropriate **governance** to ensure impact integration	**6. Engagement** of the invested companies by investors	**9. Alignment of financial interests** with the impact approach

Figure 1 - The nine criteria of the French SIF and France Invest report

To summarize, the impact investor must:

1

Have an **explicit and ex-ante defined** investment objective to address a sustainable development issue

Examples: quantified impact objectives at the launch of the fund, a committee that guarantees the integration of impact in investment decisions.

2

Beyond its financial contribution, contribute significantly to **facilitating the impact** of its investments

Examples: local support for the company, provision of methodological assistance.

3

Measure and communicate the impact of its investments

Example: be transparent about what is or is not an impact in the KPIs reported.

2 Impact investing remains a niche in the market for the time being

To understand this issue, it is interesting to compare impact investing with ESG investing, a market that is becoming mainstream.

ESG tools can, in fact, be **applied to any company**. ESG criteria analyze a company's intentions, policies, processes and internal practices. For example, the quality of human relations, the implementation of a balanced and representative governance system, waste management, etc. Any company can be given an ESG rating (depending on data availability, of course) and work to improve it. Impact investing is different in this respect. The reason for this is twofold:

Not all companies have the opportunity to have a positive impact, but they can have good ESG practices

Consider a company that designs USB cables. It can provide training to its employees or opt for less carbon-intensive materials. This will improve its ESG rating. On the other hand, becoming an impact company would imply a change in market positioning and business model: targeting people in precarious situations, offering eco-designed cables as a low-carbon alternative to conventional products. This company could become a positive impact company, but this would require a profound change in its production methods and significant resources, which are not necessarily within its reach.

The investor is therefore faced with a very small investment universe today, which will certainly grow in the future but not at the same speed as that of companies improving their ESG practices. The impact investor is faced with a structurally narrower investment universe.

The impact approach concerns all stages of the investment process.

Impact investing necessarily involves modifying the portfolio construction process. It cannot be reduced to the application of a tool or filter ("impact score", " SDG score", etc.) in an existing investment process. For example, measuring the impact of companies in a global equity portfolio by giving a score in terms of the share of sales contributing to the SDGs. Rather, it is a matter of thinking about **how to integrate impact into a particular investment process**. For example, a global equity fund that invests in companies that offer environmental solutions, with a previously established impact objective (an amount of CO2 emissions avoided, a temperature alignment with the objectives of the Paris Agreement).

This in-depth integration of impact cannot be applied overnight to "classic" or "responsible" investment processes. It represents a **strong entry barrier**, which is nonetheless essential to ensure the credibility of the impact assessment, and is therefore one of the explanations for the small size of this market.

3 Impact investing requires proximity between the company and its investor as well as detailed analysis

Unlike ESG analysis, which is generally concerned with the CSR practices of companies, impact represents all the **negative and positive externalities of a company's activities**. An illustration of these differences is presented in the table below.

However, some ESG and impact indicators may overlap. For example, the carbon footprint covers both the company's processes and its products and services.

	ESG Practices	Impact
Environmental	- The company pilots and reduces its energy consumption - The company pilots and reduces its water consumption	- The company offers solutions to reduce the emissions of other companies - The company proposes a technology / process that consumes less water than current market practices
Social	- Employees are trained annually - Opening up the recruitment process to people with disabilities	- The company offers professional training to vulnerable groups. - The company is an "adapted company"[4]
Governance	- The Board of Directors is composed of independent members - A robust internal audit system is in place	- Formalizing an impact strategy - Integration of impact objectives in the compensation policy of executives

Table 1 - Difference between ESG practices and company impacts

Impact is thus at the heart of the company's business model. Impact companies seek to articulate their social/environmental utility and their economic model. This notion of utility is specific to each company profile (type of activity, target client). It is therefore measured by KPIs that are often specific.

As part of a support and proximity approach, the impact investor opts for a personalized approach in order to optimize the impact of the invested companies. They consider specific criteria for each asset, possibly developed with the company's management. The investor is therefore often confronted with problems of aggregation at the portfolio level, even if there are KPIs with common units (tCO2e avoided, jobs created, number of beneficiaries, etc.). In some cases, the investor may not even have access to any pre-established KPIs and instead refer to a qualitative impact analysis, in close proximity to the entrepreneurs or project leaders.

As a result, the investor needs to be close to the company and its management if he really wants to be able to analyze the company's activities and their positive and negative externalities as well as the progress made. It involves the manager-analyst as close as possible to the company and its situation. This raises, of course, the question of the feasibility of this proximity, which is easier in principle for players in unlisted assets than for their colleagues in listed assets.

4 Impact investing is the tool for a necessary evolution of the investors' business model

Beyond CSR practices, a reflection on the integration of E (environmental) and S (social) issues within the company's identity has gained momentum. More and more companies are seeking B-Corp certification (3750 companies certified in 74 countries in 2021[5]). The French PACTE[6] law, signed into law in May 2019, allows French companies to include an "entrepreneurial project that meets a collective interest" in their corporate purpose *("raison d'être").* The company is questioned about its very existence and has a vocation to change fundamentally, towards a model integrating a new form of utility, beyond its economic role.

Like companies, investors can also reflect on their utility other than financial. Impact investing embodies this approach. Indeed, environmental and/or social objectives must be integrated into the very heart of the impact fund's business model, i.e., the remuneration mechanism. In private equity, for example, this can be achieved by aligning part of the carried interest, if any, with impact objectives. This is the ninth and final criterion identified by the FIR and France Invest report to define a robust impact investment approach.

Conclusion

Entering into an impact approach for an investor is a demanding process, particularly in the world of listed assets. Elements of "doctrine" and the definition of the steps to be taken have progressed significantly in recent years. Consensus among stakeholders and best practices are gradually being formalized. However, the toolbox is not yet complete.

End of Part I

>> To be continued with Part II - "Impact investing: the toolbox"

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About the environmental consulting company, I Care

I Care is a leading consulting company in the environmental field. Since 2008, I Care assists companies, financial actors and the public sector in their transition towards a low environmental impact society.

From strategic thinking to operational solutions, **I Care offers innovative solutions on a wide range of environmental challenges** with the objective of helping society to move to sustainable economy.

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Sources

[1] "Global Climate Finance Synthesis Report 2020", Climate Chance (2020). Read the report.

[2] Adopted by the UN in 2015

[3] FIR et France Invest « Investissement à impact : une définition exigeante pour le coté et le non-coté » (2021)

[4] The adapted company allows its employees to exercise a professional activity in an environment adapted to their possibilities so that they obtain or keep a job. Source: https://travail-emploi.gouv.fr/emploi/emploi-et-handicap/article/emploi-et-handicap-les-entreprises-adaptees-ea

[5] Source: https://www.bcorporation.fr/communaute/

[6] The action plan for the growth and transformation of companies aims to give companies the means to innovate, transform, grow and create jobs. The PACTE law was definitively adopted by the Parliament on April 11. Read more (in French).