WHY PE FIRMS SHOULD ENGAGE WITH SOCIAL IMPACT INVESTING

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EXECUTIVE SUMMARY

Corporate Social Responsibility (CSR) provides opportunities for various business sectors to improve their operations. Moreover, it also allows companies to better serve the environments and communities where they exist. One such means of value creation involves interacting with Enviromental, Social Governance (ESG) factors which have become a necessary part of fiduciary duties as firms respond to increasing societal pressure to engage with these facets (Alikhani, 2022; Henisz, Koller, & Nuttall, 2019). However, Private Equity firms, hereafter referred to as PE firms, typically concentrate on Environmental concerns instead of Social Governance. This report aims to persuade PE firms to engage deeper with social impact investing to place greater emphasis on Social Governance. Data utilized in this exposition was found in academic literature, industry reports, and news articles and guided further analysis and dialogues. Through discussing the strengths, limitations, and results of impact investing, this paper hopes to arm PE firms with the knowledge to change industry norms to create social impacts and profits.

BACKGROUND

Why Private Equity Firms?

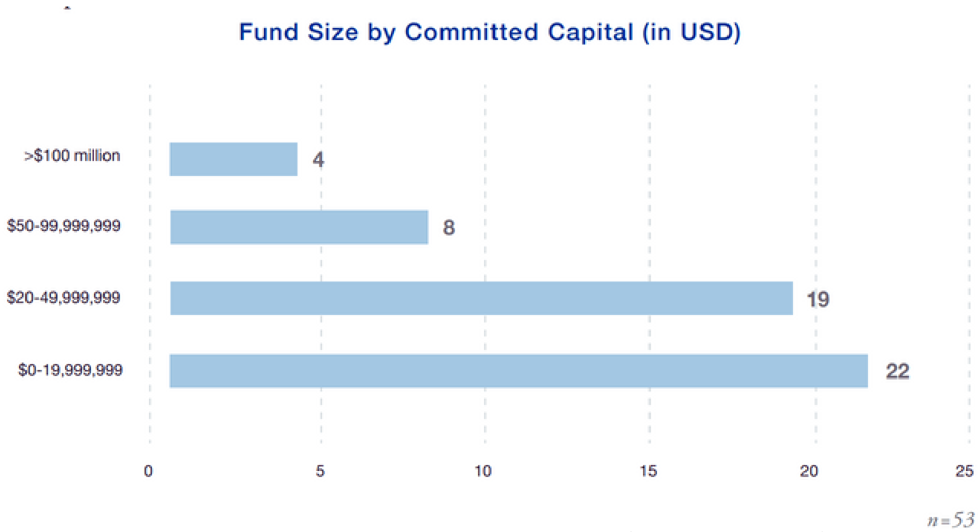
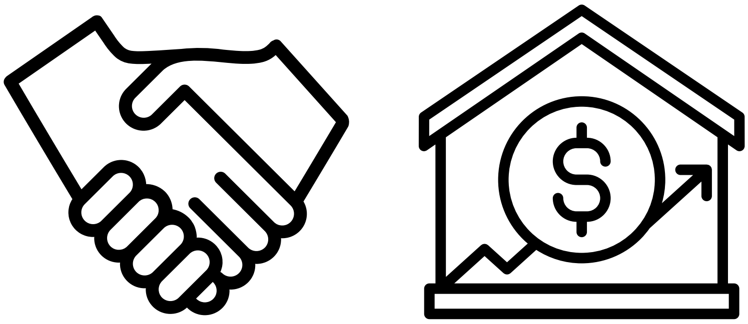


Figure 1: Fund Size by Committed Capital (Gray et al., 2015)

Private Equity plays a key role in the economy through the financing of innovation from different enterprises (Crifo and Forget, 2013). Typically, PE firms invest in high-potential companies to generate the largest return on investment for their clients. These firms can create dramatic growth and affect social problems if they become more active participants in social impact investing (Gray et al., 2015). To act as a socially responsible PE firm, one must invest in funds targeting underserved communities and support social enterprises or other companies engaging in CSR (Grace, Thornley, & Wood, 2012; Crifo and Forget, 2013). Some PE firms are already engaging in social impact investing: in 2020 there were $715 billion USD in assets in the market linking these assets to underprivileged communities (Lamy, Leijonhufvud, & O'Donohoe, 2021). However, the firms involved in social impact investing are typically smaller in fund size, as shown by Figure 1. This contrasts with the assumptions that larger funds have a larger risk appetite (Yang et al., 2019). These smaller funds are committing copious amounts of their practice to impact investing. PE firms have the necessary capital, processes, and information to stimulate social change.

BACKGROUND

Social Impact Investing Defined



Impact investment creates measurable environmental or social influences and financial returns through investments (Grace, Thornley, & Wood, 2012). One should note that impact investing has a purposefully broad definition to demonstrate its potential range of benefits and impacts (Trelstad, 2016). These specialized funds typically perform just as well as their traditional fund counterparts , no matter their size even though it is assumed they will underperform (Cortez, Silva, & Areal, 2011). There are several ways to measure its effects, the most important of which is the accounting principle of materiality (Busch et al., 2021). PE firms can utilize their investable assets to generate alternative forms of value such as tackling poverty. In fact, almost 80% of global investors are focusing more on sustainability than they did five years ago (Yang, et al., 2019). The time has come, however, to extend impact investing to involve social issues. Human rights, worker relations, and community engagement are just a sampling of civic concerns that can be considered (Grace, Thornley, & Wood, 2012).

FINDINGS

The Past Until Today

Looking back over the past thirty years provides evidence of firms participating in impacting investing. The United States has seen more growth in this area than other nations have. In 1999, the number of socially responsible funds was 168 and the industry was worth $159 billion USD. By 2007, that number increased to 260 representing $202 billion USD (Cortez, Silva, & Areal, 2011). This depicts an important trend regarding market demand. Recently, these figures have continued to increase. 2019 brought forth over thirteen thousand deals in the private market in impact investing (Geczy et al., 2021). The International Finance Corporation estimates the current market size of impact investing is $2.1 trillion USD globally (Lamy, Leijonhufvud, & O'Donohoe, 2021; Roundy, Holzhauer, and Dai 2017). Social impact investing covers a sizeable portion of that estimate: $60 billion USD (Agrawal and Hockerts, 2019). Europe and the rest of the world have shown similar interest, but the US market is considered more developed for impact investing due to its market share (Cortez, Silva, & Areal, 2011).

However, there is evidence to suggest otherwise. The European market currently contains 437 firms investing around 48 billion Euros in impact funds (Cortez, Silva, & Areal, 2011). The European market contains more firms than their US counterparts even though the size of investments is smaller. In the future, this trend may equate to larger PE firms in Europe becoming involved and altering the global market. A factor that may be contributing to the US' success is the backing impact investing has received from corporate institutions. Citigroup, Bank of America, Softbank, and PayPal have pledged billions of dollars to various social causes through impact investing (Lamy, Leijonhufvud, & O'Donohoe, 2021).

FINDINGS

The Past Until Today (Continued)

No matter the fund's location, there is a distinct overlap where the firms focus their funds. Gray (2015) found that many PE firms dedicate their investments to Latin America and Africa as shown in Figure 2. These investments each target different social causes , such as wealth gaps or racial injustice. Some firms are gender lens funds, defining themselves through investments benefiting women; in 2019, $4.8 billion USD was focused on these investments improving access to education, healthcare, and financial services for women (Lamy, Leijonhufvud, & O'Donohoe, 2021). Not even the Covid-19 Pandemic impacted the growth of this field. ESG funds performed better than the S&P 500 index by at least 0.2% to 27.9% better returns during the pandemic (Alikhani, 2022). Nothing can alter social impact investing's growth as recent economic disruptions such as the pandemic held little implications on the market. The distribution of regions receiving impact investments is becoming more equal as shown in Figure 2, but there still appears to be a slight preference for areas thought of as emerging markets (Gray et al., 2015).

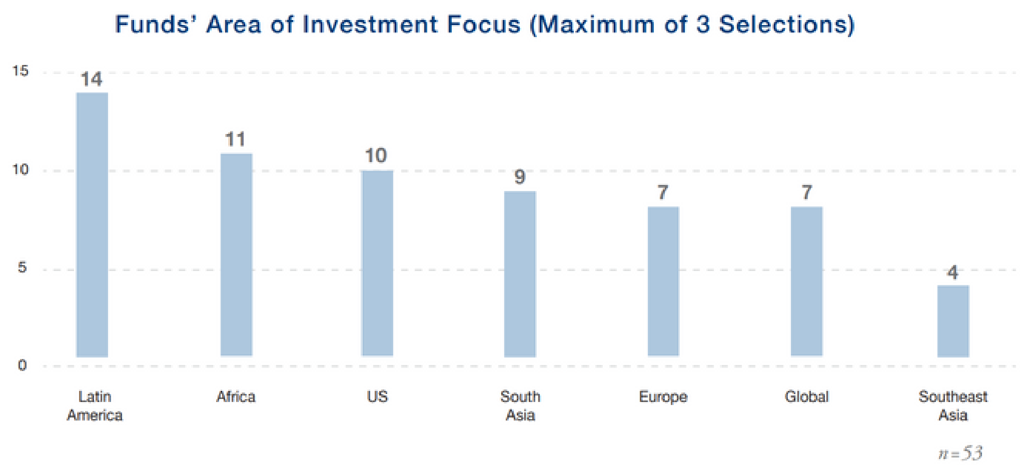
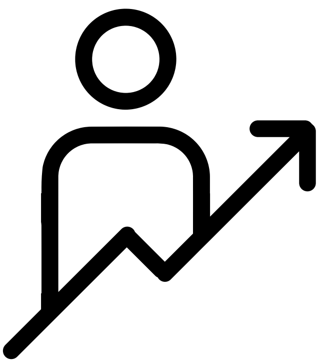


Figure 2: Funds' Area of Investment Focus (Gray et al., 2015)

FINDINGS

Projected Future Growth

The demand for impact investing continues to grow. The US market is predicted to reach $500 billion USD by 2023 (Battilana et al. 2012). This extreme growth can be attributed to younger generations of investors: Millennials and Gen X. They tend to invest in firms and stocks that align with their personal values, rather than focusing solely on economic performance (Laker, 2022). This will most likely continue as baby boomers exchange their wealth with these younger generations over the next three decades. It has been estimated that $30 trillion USD will trickle down, meaning that PE firms must prepare to meet new market and consumer demands (Yang et al., 2019). Profits are no longer the sole desire for this new era of clientele; there needs to be a purpose behind those investments, thus creating opportunities for social impact investing to take charge (Laker, 2022). Although the concrete figures of the future are still to be determined, there is no doubt about the potential which PE firms must capitalize on. The current means of investing will not necessarily remain as profitable in the future as younger generations start to become involved in these funds and demand more on the ESG side. At a smaller capital level, companies like Citizen Mint are already depicting this potential. Their platform allows users to focus their investments on social progress like affordable housing (Ibid; Geczy et al., 2021). Citizen Mint's success should inspire PE firms to follow suit in allowing consumers to make positive social capital on their investments. Social impact investing, it appears, is the future and PE firms should start to take notice.



FINDINGS

Comparisons to Traditional Investing

After examining the potential future of social impact investing, PE firms should consider their current practices. There are some similarities between the means of investing. No matter which investments are being made, firms must conduct due diligence and attempt to measure returns. The process of investing remains constant for PE firms, it is just their criteria that needs to change. However, socially responsible funds pursue different strategies to achieve their goals , like working with small capitalization stocks , rather than mature companies (Luther et al., 1992). Some of the differences between investing types can be viewed in Figure 3. The figure represents the different means of engaging with ESG as an investor. This makes the differences between traditional and impact investing even more apparent.

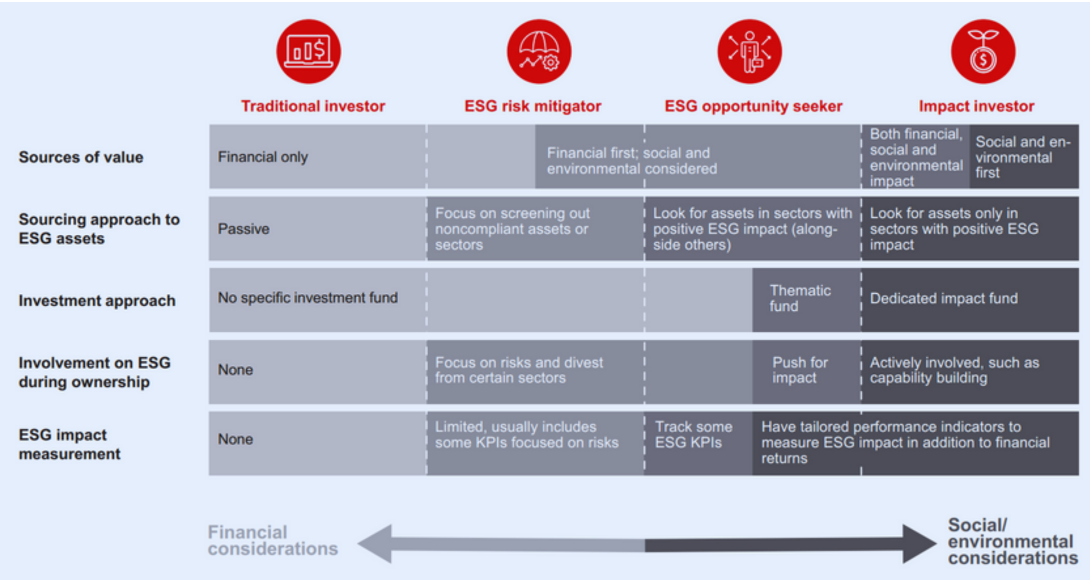


Figure 3: Investment Types (Yang et al., 2019)

One such difference is the importance of due diligence in social impact investing (Gray et al., 2015). Clients want to ensure that the companies and causes they are backing are truthful and make a positive change in society. Social impact can be difficult to measure as there are means of greenwashing or hiding aspects of their practices through public relations or marketing (Brest and Born, 2013). This, in turn, makes measuring social returns more difficult than their profit-based counterparts where deceit is harder to hide. Therefore, impact investors have specific criteria their investments must meet, also referenced in Figure 3. There are more factors to consider when attempting to establish values on social outcomes (Ibid .). Social impact investing further differentiates itself as it creates value through social impact and financial return a drastic departure from the typical dichotomy which prioritizes high financial returns (Emerson, 2003; Nicholls, 2010).

DISCUSSION:
BENEFITS OF SOCIAL IMPACT INVESTING

The clients that employ PE firms typically have large assets and capital investments which they assume will gain a positive return (Grace, Thornley, & Wood, 2012). PE firms have historically provided means for profit maximization through acting efficiently and maintaining low agency costs (Kaplan and Stromberg, 2009; Jensen, 1989). This is, in part, due to management oversight, high use of debt, and skilled talent. Clients, then, receive a high return on their investments. These factors also contribute to why PE firms should shift their operations to include social impact investing in their purview. These firms are well positioned for this development because they already operate with a high volume of capital which can allow them to take part in the necessary due diligence, risk management, and compliance for success (Crifo and Forget, 2013). As such, social impact investing can create additional value for firms of any size (Geczy et al., 2021). This, in turn, would allow PE firms to bring impact investing into practice in the wider financial sector (Crifo and Forget, 2013).

Additionally, there are alternative reasons why PE firms may want to engage with social impact investing. Governments and policymakers have created several schemes and initiatives to support institutions working with these investments. Some of these programs dedicate resources to reduce risks and provide legal flexibility (Grace, Thornley, & Wood, 2012). Others have governments as active partners in their decision-making procedures which creates new opportunities for both parties (Hebb, 2013). These coordination efforts between firms and governments can aid the development of the market and further social impacts (Grace, Thornley, & Wood, 2012).

DISCUSSION:
BENEFITS OF SOCIAL IMPACT INVESTING

There are many other benefits impacting investing brings forth. Engaging with ESG in any capacity attracts new clients. PE firms gain a competitive advantage to address the new developments in consumer demands (Ormiston et al., 2015). No longer is impact investing thought of as micro-finance opportunities; instead, they advance innovation in social missions (Yunus and Weber, 2007). By aligning their firms with these practices, new limited partnerships can be formed (Crifo and Forget, 2013). Research suggests that this market continues to grow. Firms that capitalize on the market can remain competitive in the future. It has been argued that impact investing may become an emerging asset due to its growth and value (O'Donohoe et al., 2010). PE firms can incorporate social impact investing into their strategies to increase investor engagement and differentiation (Crifo and Forget, 2013). These positive externalities discussed also do not encapsulate the benefits these investments provide to the people impacted by the social causes. Investments in areas like education and healthcare can drastically improve the circumstances of both individuals and their greater communities. Social impact investing allows PE firms to champion these causes and gain more clientele and assets in the process.

DISCUSSION:
LIMITATIONS TO CONSIDER

Although there are copious benefits involved with social impact investing, there are also limitations to consider. The three main limitations surrounding impact investing distinguish themselves through the measuring of impact, management of expectations, and attending properly to the process correctly. Most of the concerns surrounding impact investing concern how to accurately assess the impact it extends (Brest and Born, 2013). This lack of knowledge should not be taken into account lightly , as it may prove a detriment to the long-term success of the field (Agrawal and Hockerts, 2019). PE firms need to collect and analyze data surrounding their investments. Although this is already done in conventual practices, impact investing requires much more information. Moreover, they would be required to keep track of the progress made. There are additional concerns regarding greenwashing investments where no real impact is created (Starks et al., 2017). Expectations must also be managed from both the client's and company's point of view. PE firms may struggle to maximize returns while conducting the necessary due diligence and monitoring of investments (Gray et al., 2015). It will take time to find the proper balance between financial returns and social impact. The time it takes PE firms to perfect their practice may cost them millions of dollars (Agrawal and Hockerts, 2019).

DISCUSSION:
POSSIBLE ISSUES

Despite these positive externalities, there are some flaws one can source in the data and theories surrounding social impact investing. Trelstad (2016) even claims that the definitions of impact investing make assumptions that confuse investors and investment opportunities alike. Some of these thoughts concern the lack of impacts that are made through these channels. Board of Directors and high-profile clients can create their own stipulations in their contracts which create limitations. Even if these groups are not attempting to lessen their impact, they also may be considering their investments to be venture philanthropy or venture capital which focuses less on people in need (Agrawal and Hockerts, 2019). Moreover, numerous studies have reached different conclusions about the relationship between impact investing and financial performance. Although the current consensus states that there is a positive correlation between returns and causes, many would argue otherwise. Some even claim that there is not enough information and data to make any of these claims (Revelli and Viviani, 2014; Markowitz, 1952). Furthermore, the comparisons conducted in these studies remove variables that impact performance such as the skills of the fund managers and the length of the funds (Kempf and Osthoff, 2007). Current adjustm ents can be made to mitigate these concerns but necessitate further research and analysis to do so.

CASE STUDIES

Should PE firms hesitate to alter their practices, it may be valuable to look towards the firms which have already done so with remarkable success. The following examples have notable commonalities between them, including a specific mission for their business focus as well as the continuation of investing in the same funds. The two firms investigated here are LeapFrog and Lok Capital. LeapFrog's first focus as an impact investor was microinsurance to aid small businesses' finances for the poor (Yang et al., 2019). Since then, they have slightly broadened their company mission to include high-growth companies making their own social impact (Ibid.). Included in their vision as a PE firm remains the desire to create high returns for their clients. The table below provides a summary of their funds over their history, showing Consistent increased growth and impact is something LeapFrog id proud of as a PE firm. Their investments are typically companies in Asia and Africa in the healthcare and financial services sectors (Ibid.). Their investments also create growth for the businesses involved. 122,00 jobs and average 40% growth can be attributed to LeapFrog (Ibid.). LeapFrog does not only provide capital but management experience and assistance in applying for other grants (Ibid.).

LeapFrog	**First Fund**	**Second Fund**	**Third Fund**
Amount Raised	$135 Million (USD)	$400 Million (USD)	$600 Million (USD)

Lok Capital is a smaller PE firm that has a narrowed business mission and geographical focus. Their mission aims to improve financial and social inclusion in India (GIIN, n.d.). Lok Capital fosters growth in minority populations by investing in small enterprises typically in healthcare, agriculture, or financial service sectors (*Ibid.)*. The aim is for these services to become more affordable for those that need them. The table below reviews their portfolio over the past several funds.

Lok Capital	**First Fund**	**Second Fund**	**Third Fund**
Amount Raised	$22Million (USD)	$64 Million (USD)	$80 Million (USD)

Similar to LeapFrog, there has been an increase in capital raised. However, there are some differences between these funds. Lok Capital has a much narrower focus which provides them with some distinct market advantages. For example, it is easier to measure and compare impact when their geographical area is smaller. Furthermore, although the firm raised smaller amounts of capital, they are more integrated in the communities they invest in as well (*Ibid).* No matter the exact means of engagement, both firms provide examples of the profitability inherent to social impact investing and concrete examples of the impact made.

CONCLUSIONS

Social impact investing is a growing field of interest for PE firms. Although it has limitations and inherent risks, the benefits far outweigh these drawbacks. Lok Capital and LeapFrog each provided examples of how PE firms can concretely engage in social impact investing. They have both been successful in participating in means of improving people's circumstances through improving housing, food, or finance opportunities. They also proved that no matter how large or how small the fund, there is still an impact to be created. As it is emerging that this sector will generate large amounts of growth in the future, PE firms should consider shifting their current business strategies and practices now. Younger generations of investors have shown a preference for investing in companies making the world better rather than chasing profits. By choosing a limited geographic focus and business mission, PE funds can adopt social impact investing as an area of their portfolio with relative ease. Furthermore, governments can act as partners to limit some of the risks.

RECOMENDATIONS

For social impact investing's potential to be fully realized, a multitude of stakeholders will have to collaborate and dedicate themselves to its mission (Ormiston et al., 2015). Part of this process will include sharing information about its procedures and impacts. Preconceptions such as impact investing producing lower profits will have to be overturned (Yang et al., 2019). However, there are plenty of firms like Lok Capital proving that claim to be inaccurate. Firms will have to work with their clients, governments, and wider society to ensure the promised positive effects are accurate. Funds will need to determine their own criteria to mitigate risk, source investments, and seek investors (Ibid.). To better engage with social impact investing, PE firms must shift their current perceptions and strategies. For instance, firms must move beyond financial performance and focus on the social transformations their investments make (Capelle-Blancard and Monjon, 2012). PE firms must undertake the necessary social responsibility shared by their stakeholders and reflect that in their strategy (Revelli and Viviani, 2014). Possible next steps should include collaboration between firms to create a standardized, industry-specific impact framework to measure social effects developed through investments (Busch et al., 2021). Moreover, PE firms should develop their own goals and standards to hold themselves accountable. This would allow for stricter regulation, limit confusion, and allow social impact investing to reach its potential (Trelstad, 2016). PE firms should engage with social impact investing and put purpose before profits. This may appear like fringe ideology now but will not in the future. The only question that remains is if PE firms are up for this challenge.

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