There is no such thing as impact, but only proof of impact

November 2018

By : SEVERINO Jean-Michel, DEBLED Emilie, NOCQUET Emilie, BOURRIN Clémence

I. The impact investment market is taking shape and gaining momentum...

The impact investment market is currently experiencing strong growth, fueled by the keen appetite of investors around the world and by the ever-increasing needs present on the ground. In 2018, 229 organizations took part in the Global Impact Investment Network (GIIN)'s seventh *Annual Impact Investor Survey* and reported having invested $35 billion into more than 11,000 deals in 2017 alone. Respondents also indicated they expected their business to grow by 8% in 2017, confirming the positive trend anticipated for this market. Many investors have indeed begun rethinking their approach to impact investment, adapting existing tools or creating specific instruments to this new form of financing. Some such examples include the Social Business facility fund created by Proparco, the private sector affiliate of the French Development Agency, and an "Impact Investment" envelope now managed by the European Investment Bank. Others, such as the European Commission and the World Bank, have built major impact investing vehicles from budgetary resources. These dedicated financing tools reflect a growing interest in impact investment on the part of development financial institutions (DFIs) and may be the first steps of large-scale deployment with private capital crowding-in.

Private funders are also showing a growing interest in impact investment. A large number of banking and insurance groups have created and now implement "funds of impact funds". This approach is not only part of their CSR policies, but also responds to a strong demand from subscribers and clients who wish to mobilize their savings for causes with a social and/or environmental impact. A particularly noteworthy initiative in terms of size and approach can be highlighted in this area: AXA Investment Managers, which is currently investing a €150 million fund of impact funds. The AXA IM team, composed of financial professionals and impact and specialized lawyers, is able to study with a cross-cutting approach all impact investment opportunities that may exist today on the market in all sectors and all geographies. Other leading French players, such as Natixis (Mirova) and Amundi are also involved moving in the same direction, with their own terms and conditions.

Along with this growing interest in and proliferation of “impact” initiatives, endless discussions in the world of impact investing are being had to try and define what "impact" is. In fact, it is very difficult to define it precisely because there are as many forms of "impact investment" as there are impact funds. Each impact team determines a cause of general interest to which it intends to contribute, defines an investment strategy to support a target - often under-served - and designs an impact measurement system adapted to its targeted issue. Finding a common framework for measuring impact has seemed to be the answer to these definition problems. But here too, each impact thesis has its own indicators and its own impact measurement system.

IMPACT WASHING – A THREAT TO THE IMPACT INDUSTRY

As impact investment has gained in popularity, the temptation has become ever greater for profit-oriented public or private funds to complete their investment thesis with a speech on their social impact. In some cases, companies declare themselves impact vehicles in order to optimize their chances of attracting investors. These practices are known as "impact washing". In the vast majority of cases, the impact speech consists of a presentation of the fund's contribution to employment, growth, or a particular sector or theme. However, these are typically impacts that any well-managed company could generate. Well-managed companies indeed have positive net impacts on society and the economy: if this were not the case, there would be no legitimacy for the capitalist or liberal system. To qualify such effects as "impact investing" is misleading: it implies that there is no trade-off, in any case, between profit and impact - and therefore that investments with weak returns are simply bad investments. Defining a common framework is the key challenge that will be faced by the impact investment market and all of the actors that drive it. Making a clear distinction between serious, rigorous and resolutely oriented public interest initiatives and those which tint conventional or responsible investment strategies with the polish of impact is vital to the integrity and legitimacy of true impact investment.

We are at **a critical stage in the development of the sector**. In order to enable it to grow on sound and solid foundations, it is essential to provide it with common, concrete and measureable frameworks.

The Global Impact Investing Network (GIIN) defines impact investments as *"investments made in companies, organizations, and funds with the intention of generating a social and environmental impact coupled with a financial return."*

Intentionality is at the heart of the definition of impact investing. However, intentionality is by definition of a declarative nature and does not necessarily translate into action. The purpose of this article is to provide a frame of reference for those who wish to make their intentionality more tangible, to adhere to the transparency and credibility of the sector as a whole and to make it more difficult to use the claim of impact investing as a trendy marketing strategy…. Our goal is to:

- Enable a better understanding of the sector through an open and transparent approach
- Share good practices and proven tools, promote their harmonization and increase the professionalization of actors
- Mobilize additional funding towards impact funds by promoting better knowledge and ownership of backers.

II. How can impact intentionality be embedded in investment activities?

To help concretely embed impact intentionality in impact investing activities (See Annex 1), we offer a matrix of three I's: "Impact thesis and targets, indicators and incentives", which are based on our experience and good practices observed among our peers.

Impact thesis and targets

Any intentional impact approach must entail a preliminary explanation of the common good issue being targeted and answer three main questions: What is the nature and extent of the social and/or

environmental problem to be solved? What investing activities should be undertaken to address this issue? What are the expected effects on the target population? This general impact thesis can then be broken down into a set of specific impact objectives to be achieved through the investments and their main stakeholders (clients, employees, subcontractors, etc.).

These impact objectives need to be linked to the new Sustainable Development Goals, as a harmonized international standard. Their credibility, however, relies directly on the investments' local context, which should be duly documented: as an example, if a job creation objective is fully relevant in some target areas and populations, it may not be in others.

Internally, the team will be united around precise and credible objectives. These goals will provide an objective, clear and measurable ("SMART") basis for selecting investment projects according to their expected impact and allow the team to monitor and evaluate the impact once the investments have been made.

Indicators

We act according to what we measure: to ensure a true impact-led investing strategy, key performance indicators ("KPIs") must be implemented to assess performance all along the impact value chain:

- **From resources committed to investing activity**, namely **inputs**, such as capital invested, level of managerial support (in person-days, weeks..) or number of technical assistance missions organized;
- **To tangible results from the investing activity**, namely **outputs**, such as the number of companies financed and supported, the leverage effect of the investment on other funding sources, the company profitability and growth;
- **To the main changes and effects on the target population** at the investee stakeholder level, namely **outcomes**, such as the basic goods or services provided to local residents or the number of jobs created by investee companies, etc.

Going further would involve a scientific evaluation of **impacts**, as longer-term outcomes adjusted for what would have occurred anyway (without the investment, as an example). However, impact evaluation in its strictest sense remains a challenge for the impact investing industry, as explained in the next section.

It is also necessary to question the fund's objectives at two levels:

- **At the portfolio level**: which indicators or ratings are relevant and easy to collect for all investments?
- **At the level of each investment**: can we define some key company-specific indicators? To go further, it may be appropriate to build an impact-based business plan, specifying impact targets to be achieved year after year or even a comprehensive logical framework, derived from philanthropy projects and development aid methods.

Depending on the objectives and the means available, several forms of evaluation can be considered, including regularly collecting impact metrics, defining practice ratings, and conducting field surveys, as detailed in the next section.

Incentives

An impact investing team's commitment to impact performance can ultimately be reflected in financial incentive structures. In recent years, several impact funds have developed impact-based incentive structures, which tie "carried interest" or other kinds of team compensation, not only to financial objectives, but also to extra-financial ones. These pilot initiatives come from impact fund managers[1] or some of their investors, such as the European Investment Fund, which makes this a pre-requisite for any funding and has developed a specific method.

In practice, these approaches can be complex to implement, especially for "open-ended" funds or for recent funds without an impact management track record. They can also be poorly viewed by some teams, who consider that impact motivation is in no way linked to compensation.

However, these systems include some valuable benefits: they promote a shared impact vision between investors and fund managers and enable impact management to become a key topic for monitoring and governance. They also enhance the reliability of impact measurement systems if combined with external audit mechanisms on target indicators. Finally, they pave the way for similar approaches in investee companies.

III. How to prove impact?

To complete this overview, a final question remains: what do impact funds have at their disposal to fully carry out their impact objectives in practice?

Human and organizational resources

Fund managers should be at the forefront when setting up and implementing an impact policy. This is particularly crucial for the investment team, which must fully take into account the impact objectives and ESG criteria when evaluating a deal. Specific and ongoing training on these issues is necessary. Many funds opt for a specifically dedicated team to the management and monitoring of the impact policy to coordinate the approach and share experience.

To go further in the implementation of the impact thesis, a mission-driven form of governance should be implemented. As an example, ad hoc impact committees can be formed to review the fund's impact management policy and submit proposals with regards to various ESG and impact issues (strategy definition, performance analysis, etc.…). In addition, it is critical to ensure that the Investment Committee possesses impact management skills to challenge the investment projects on these dimensions. This approach has been adopted by I&P for its most recent funds. Finally, external audit mechanisms or certifications, such as GIIRS ratings[2], will enhance the reliability and credibly of the impact management system.

---

[1] Examples of impact-based incentive structures implemented in impact funds are included in this issue brief from the GIIN: https://thegiin.org/assets/documents/pub/impact-based-incentive-structures-aligning-fund-manager-comp.pdf

[2] http://b-analytics.net/giirs-funds

Impact tools

A series of hands-on tools should be put in place to facilitate impact monitoring and evaluation. These tools are indeed useful throughout the entire investment process, including during the due diligence phase. Based on its core impact objectives, I&P has, for instance, developed an **impact screening scorecard**, which allows the team to assess the potential project impact on its key stakeholders (employees, clients, subcontractors) and make sure the project is aligned with the impact thesis of the fund. The scorecard lays the groundwork for further discussion on the project. **Impact measurement tools** are used to track the results of the portfolio during the investment period. These tools are based on a series of impact metrics, some common to all investees and some specific to each business.

After several years of impact measurement at I&P, we have noted that portfolio-wide aggregated impact indicators have refined our understanding of already well-known impacts, and also represent a powerful communication and goal-setting tool for new funds. They remain, however, insufficient to allow us to understand the complex realities of each partner company: for this we need to go out in the field and meet the company’s employees, customers, producers and distributors to get to know them better and identify actions for improvement. Such field studies are based on a multi-week field survey and provide valuable insight into a company's impacts on its stakeholders and environment.

Unfortunately, due to limited resources, these evaluations can only be conducted on a limited number of investments. These assessments are closer to more rigorous impact measurement and are instrumental to “improving” operations and promoting a culture of learning. However, they do not "prove" any impact in the scientific sense of the term: in the absence of "counterfactuals", the impacts observed on the ground cannot be attributed precisely to the investment made, and their duration, beyond the evaluation period, cannot be measured.

Each fund may develop their own tools, those best suited to their needs and impact objectives. What ultimately matters is how well team members – and investees – are able to understand and make use of/leverage these tools.

Communication and transparency

Last but not least, impact funds should openly communicate on their methodology and impact results, not only for the sake of transparency but also to share good practices among practitioners in the spirit of the sector itself. Without exposing its investees, a fund can communicate the aggregate impact figures collected annually, providing evidence of how these results have contributed to its impact objectives. It is equally important to present *how* these results were identified and *how* they have been attributed to the fund.

Let’s not forget here the importance of networking and peer-review: there is much to learn in observing how other funds are proceeding and in sharing what is working.

Conclusion

A famous French saying claims, “There is no such thing as love but only proof of love”. We could say the same about impact investing.

True impact investment goes well beyond declarations of impact or lofty speeches. As impact investors explicitly aim to contribute to a public cause through the use of a market instrument, their methodological approach consists in first identifying this objective, getting organized and incentivized, and then accepting the consequences, in terms of financial profit (or lack thereof) associated with their objective. In some rare sectors, it is possible to combine high returns with an impact thesis. However, even in such cases, the legitimacy of an impact approach is rapidly weakening as the level of expected profitability is beginning to attract conventional investors. In practice, it is often necessary to make trade-offs between profit and impact. This is why a rigorous process of qualifying, measuring and evaluating results, as well as aligning interests, as presented in this paper, is essential for several reasons: to justify and legitimize the trade-offs between performance and impact that we have just highlighted, to outsource the societal-added value that is at the heart of the impact investing process, and to differentiate between “true” and “fake” impact investors... To present proof of impact is the only proof of true impact investing.

Bibliography

DCED, Juillet 2017, Attribution in Results Measurement: Rationale and Hurdles for Impact Investors

GIIN, 2017, *Annual Impact Investor Survey*

Novethic, Juillet 2017, *Les investisseurs en quête d’impacts. Stratégies, innovations et défis*

Issue Brief, GIIN, Impact-based incentive structures, December 2011