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AEGON Asset Management

Private markets: (em)brace for impact

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Executive summary

Vertical farming, access to education, decarbonizing industrial processes. These are just some examples of themes that private equity impact funds invest in. Impact investments have a clear social and/or environmental purpose alongside a financial return objective with the intention to be a force for good and clearly measuring the impact. In this paper, we describe the private equity impact investing universe and provide guidelines for selection of appropriate impact funds. Our key findings are:

- Private equity is a well-positioned asset class to make impact. Fund managers often take a controlling stake in a company leading to considerable influence to deploy dedicated impact initiatives. Private companies often focus on new, disruptive technologies, are flexible to change their business model and can quickly scale up.
- We classify impact funds as either small specialists, small generalists or large generalists that differ in fund size and number of investment themes they focus on (specialists aim to make impact in one or two investment themes or SDG's). Smaller funds have a greater potential to make impact whereas larger funds are typically better governed but run a greater risk of *impact washing* (reported impact deviates from actual impact).
- Selecting a suitable impact fund raises additional considerations: what and how much impact does the fund intend to make? Why has the fund manager started an impact strategy? Are financial incentives aligned with impact goals? How is impact measured? Selecting the appropriate fund is key to achieving the financial and impact objectives.

For more information about our capabilities in manager selection & monitoring, please visit **www.aegonam.com/en/fiduciary-management/manager-selection-and-monitoring**

Introduction

Impact investing is not new, but the development around dedicated private equity impact funds has accelerated in recent years. Increasing political and social pressure, growing awareness among customers and businesses and the emergence of sector initiatives have helped to create a favorable environment for impact investing. Both the supply of impact funds coming to market and the demand for impactful investments have seen a rapid growth in the past years. Although diverse in their impact framework, ideas on what impact investing is, themes they focus on (e.g. climate, human wellbeing, energy transition etc.) and execution, the overarching goal is clear: to contribute purposefully, intentionally and measurably to a better world. Impact investments are often aligned with the Sustainable Development Goals or the Paris Climate Agreement and adhere to high reporting standards.

In this white paper we explore the private equity impact investing space based on our own observations, discussions with impact investing funds and external research reports. First, we need a clear understanding of impact investing: what is it and why are private equity managers becoming increasingly active in this area? Second, we dive deeper into the impact investing themes that are often targeted by impact funds, including several examples. After that, we map the impact universe and develop a framework where we cluster impact funds based on common characteristics. This can guide investors in shaping their ideas on how to engage in impact investing. Finally, we show additional selection criteria that investors can use to select the most appropriate impact fund.

1. The what and why of impact investing

What is private equity impact investing?

Industry-leading organizations have a clear picture of what impact investing is, even though individual fund managers can have their own definition. Many of the definitions below share common elements.

Organization	What do they mean by impact investing?
IFC International Finance Corporation World Bank Group	An approach that aims to contribute to the achievement of measured positive social and environmental impacts alongside financial returns[1]
PitchBook	A strategy of investing in enterprises, organizations and funds that seek to create both financial returns and measurable social and/or environmental impact[2]
Phenix Capital	Investments with the dual mandate of financial return and positive societal or environmental impacts, with the notion of measuring the positive and negative impact of investments, ensuring both intentionality and additionality among these[3]
GIIN Global Impact Investing Network	Investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return[4]
Operating Principles for Impact Management	Investing into companies and organizations with the intent to contribute to measurable positive social or environmental impact alongside financial returns[5]

In our view, impact investments are:

- *Purposeful*. They have a clear positive social and/or environmental influence. It goes beyond integrating ESG factors in the investment process and surpasses concepts such as negative screening or best-in-class investments. Social and environmental influences are often part of one or more investment themes as defined in the next chapter.
- *Intentional*. There is a strong will to be a force for good, which individual investors often link to philanthropic goals. Having a positive social and/or environmental influence with investments is at least as important as financial goals.
- *Measurable*. There should be clearly defined KPI's that track the impact over the life of the investment. The most widely known impact framework is from the Impact Management Project, a collaboration between 2,000 organizations[6]. Some impact funds have developed their own impact framework (sometimes with the help of an external party) to align with their specific focus. Impact is sometimes also measured as the contribution to one or more SDG's, for example the amount of clean water produced from waste water (SDG 6).

Measuring impact: the baseline obstacle

Impact should always be measured relative to a baseline or benchmark. For example, the impact of a company investing in a technique to improve crop yields should be measured relative to the crop yields without that specific technique. Maybe the crops would have yielded more anyway, e.g., due to favorable weather conditions. Measuring this often depends on models and therefore on assumptions and input parameters. Identifying the baseline becomes even more challenging for venture capital investments (for example, a start-up investing in a new, disruptive technique for reducing GHG emissions) where most of the impact lies in the future.

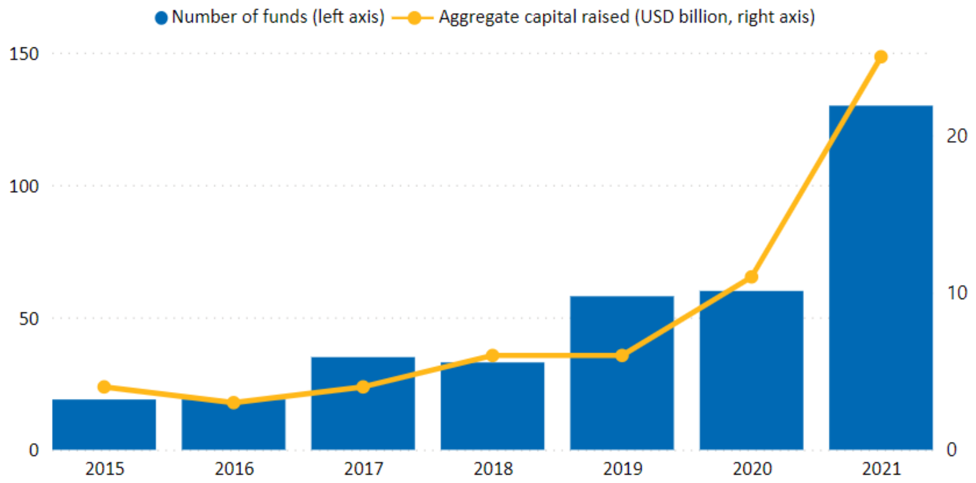
Why are private equity funds turning to impact investing?

The increasing support from governments, growing awareness among customers and businesses and the emergence of sector initiatives have helped to create a favorable environment for impact investing. There is growing consensus on the importance of having a positive social and environmental influence and the role that capital can play. The graph below

[1] www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/development+impact/principles
[2] pitchbook.com/blog/what-are-the-differences-between-sri-esg-and-impact-investing
[3] www.phenixcapitalgroup.com/impact-definitions
[4] thegiin.org/impact-investing/need-to-know/#what-is-impact-investing
[5] www.impactprinciples.org
[6] impactmanagementproject.com/impact-management/impact-management-norms/

shows an impressive increase in impact funds that came to market in 2021, where the number of funds (blue bars) and aggregate capital raised (yellow line) has also steadily risen in the previous years.

Fundraising of impact funds by vintage year



Source: Preqin

The rise in fundraising last year can partly be attributed to large private equity houses that came to market with an impact fund. Examples include *EQT Future*, *TPG Rise Climate* and *Apollo Impact Mission*. Although these large players can have a genuine motivation to start a dedicated impact strategy, it may well be that they are looking to gather more assets or are jumping on the impact bandwagon because competitors are doing the same. In our view, the risk of *impact washing* (reported impact deviates from actual impact) is greater with these larger players. We have seen an example of such a large impact fund acquiring an 'ordinary' dentist chain and classifying it as social impact as it improves people's wellbeing.

Private equity is a well-positioned asset class to make impact. Private equity funds often have a controlling stake in a company meaning they have considerable influence and can employ dedicated initiatives to create impact. Furthermore, companies under private equity ownership often focus on new, disruptive technologies, are more flexible to e.g. switch to renewable energy and can quickly scale their businesses. As such, private equity is operating at the heart of the real economy and therefore has a significant potential to make impact.

Impact and ESG: colleagues or competitors?

Impact investing goes beyond incorporating ESG and non-financial criteria: social and/or environmental impact goals are set beforehand alongside financial objectives. These impact goals are more ambitious than ESG criteria, are measured more explicitly and are aimed at specific themes. Impact is intertwined with a company's business purpose and is achieved by new, disruptive operational practices and/or the products and services that the company delivers, for example smart energy meters to help customers reduce their energy usage. An impact KPI could be the lower kWh consumption by customers linked to an impact objective of reducing GHG emissions.

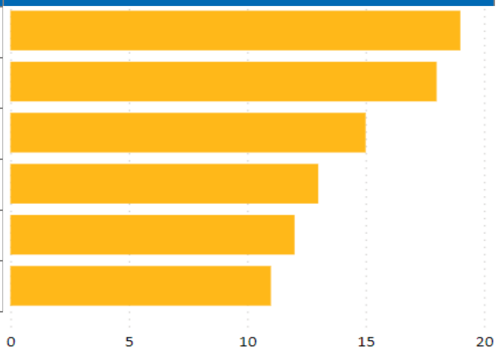
Other distinctive characteristics of impact funds include:

- Often, the performance-based compensation (carried interest) is linked to specific impact KPI's. In our view, this expresses the manager's motivation to make impact. For example: the Morgan Stanley Climate Impact Solutions Fund tied carried interest to their fund objective of a reduction of 1 gigaton of CO_2 over the fund's life.
- Many funds have a long-hold strategy, meaning that they aim to hold portfolio companies for 5-8 years.
- Especially large private equity players have attracted prominent politicians or business leaders to help them market the impact investing strategy and provide a network. For example, EQT Future partnered with Paul Polman (former CEO of Unilever) and TPG with singer Bono and Hank Paulson (former U.S. Treasury secretary).
- Some of the smaller, more specialist impact funds are set up by former partners of larger players. The fact that they left their former private equity firm may signal a genuine interest in making impactful investments.
- Impact funds have an additional risk of not meeting their impact objectives, next to not meeting the financial objective. However, some impact funds simply start with an impact ambition and crystallize out the specific impact KPI's along the way. Especially funds with highly diverse portfolio companies use tailored KPI's.

2. Investment themes

We have made a categorization of impact investments into six investment themes in the table below. It shows which topics a theme includes and how often an impact fund from our long list (currently 45+ funds) focuses on a particular theme. For example, roughly half of the funds focus (among other things) on the climate theme. Themes often overlap with a particular SDG. For example, climate (change) matches SDG 13 and food can be linked to SDGs 2, 12, 14 and 15. Impact investing advisor Phenix Capital researched which SDGs the funds that are currently raising capital are targeting[7]. The top-3 are SDG 3 (*good health*, $6.6 billion), SDG 7 (*clean energy*, $5.2 billion) and SDG 9 (*innovation & infrastructure*, $4.6 billion).

Theme	Topics	Number of funds that focus on the theme
Climate	Decarbonization, 'greening' industrials, transport, pollution	
Energy transition	Hydrogen, electrification, renewable energy, energy grid	
People/wellbeing	Education, diversity & inclusion, health, human progress	
Food	Agri technology, sustainable fishery, alternative proteins	
Resources	Water, resource efficiency, circular economy, biodiversity	
Technology	Smart cities, connectivity, Internet of Things, biotech, fintech	



Based on Aegon Asset Management's private equity impact long-list

Most impact funds manage a broad strategy and focus on multiple themes simultaneously. A combination of social and environmental themes – or 'people and planet' – is commonly used. Specialized fund managers with a niche strategy often direct their investments to energy(transition) and food(technology). These themes often encompass the development of new technological solutions. This includes funds with a very narrow focus as well, for example:

- Netherlands-based Aqua-Spark invests worldwide in companies contributing to sustainable fishery (improved fish food, solutions for fish manure, more 'productive' cultured fish).
- The British manager Hycap invests solely in companies that advance the British hydrogen economy such as a manufacturer of buses that drive on hydrogen or solutions to develop the hydrogen infrastructure.
- The Finnish UB Forest Industry Green Growth Fund focuses on forestry and the use of wood as an alternative to products based on traditional fuels. Examples include wood-based packaging instead of plastic, the use of wood mass as alternative fuel and wood-based textile instead of cotton.

Climate tech in The Netherlands

Within the Dutch start-up ecosystem, climate tech is nowadays regarded as a distinct investment theme. It includes topics such as *agtech* (agricultural technology, about sustainable (vertical) farming, using drones and GPS), *clean energy* (energy transition, smart meters and sensors, optimizing the energy grid) and *foodtech* (food technology, about optimizing food production and alternative proteins like plant-based meat and micro algae). The Netherlands has a leading position on climate tech efforts within Europe. Last November, the *Financieele Dagblad* reported that Dutch venture capitalists have raised nearly €620 million of climate tech seed capital in 2021, five times as much as in 2019[8]. This amount represents nearly one fifth of all investments in Dutch start-ups.

[7] Phenix Capital 2022 Impact Fund Universe Report
[8] fd.nl/bedrijfsleven/1417146/durfinvesteerders-steken-een-recordbedrag-in-nederlandse-klimaatstart-ups-pnc2cam5g4AS

3. The private equity impact universe

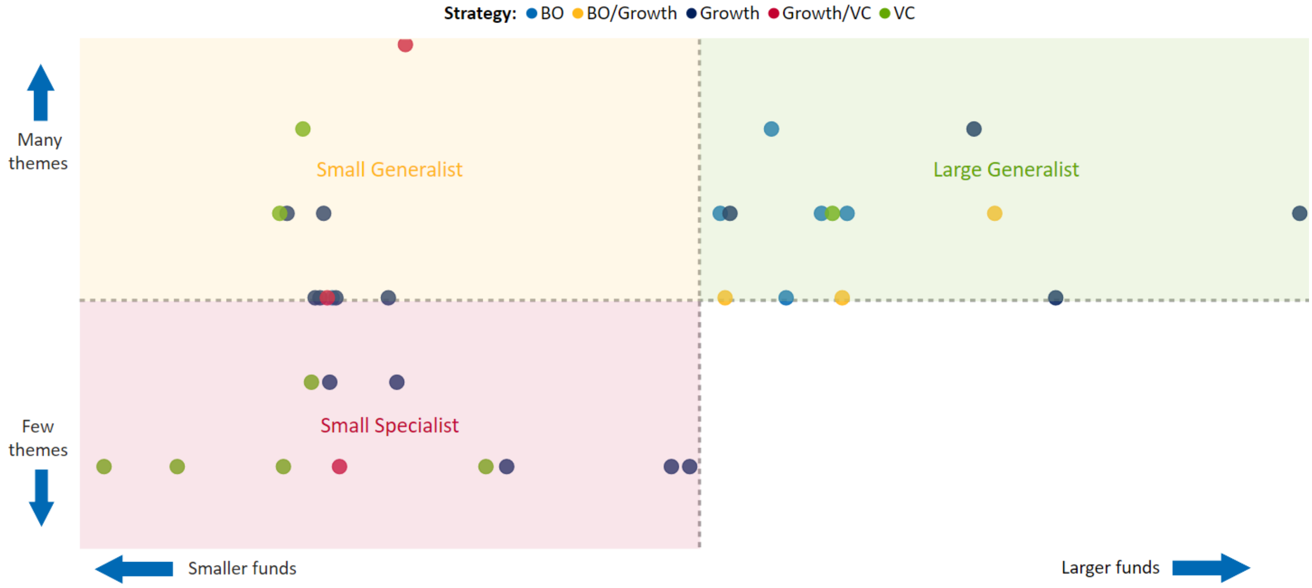
At the start of 2021, Aegon Asset Management intensified researching the private equity impact space, by mapping the universe and asking fund managers explicitly about their impact investing efforts. Currently, almost 500 private equity managers are raising an impact fund[9]. We identified around 45 managers with a valid impact proposition, with the number growing monthly. These 45 managers constitute the long-list that we have an active dialogue with.

The impact roadmap

When zooming in on the universe, we can cluster the funds into three groups and make some observations on each of them. The framework below classifies the funds (the colored dots) based on two dimensions:

1. Fund size (x-axis): larger impact funds are almost always raised by a large private equity house that employs multiple strategies. Examples include the impact funds of KKR, TPG and EQT that recently started an impact strategy next to their VC, buyout, infra and/or private credit strategies. On the left-hand side of the spectrum are the smaller funds with a fund size up to €1 billion The smallest fund in our universe is €30 million. These (very) small private equity managers solely employ an impact investing strategy.
2. Number of investment themes the fund focuses on (y-axis): we distinguish specialists from generalists. Many funds focus on just one or two investment themes or SDG's. These specialists often target the themes of food technology or energy transition. Generalists target three or more themes.

Mapping the impact universe



Furthermore, the color of the dot shows the investment strategy. Several funds do not follow a pure venture capital (VC), growth or buyout (BO) strategy, but rather a combination, such as growth and buyout. In some cases, the strategy followed overlaps with other asset classes. For instance, Impax AM is involved in complex wind and solar parks which they classify as 'infra private equity' and SGM uses convertible loans (financing instrument with a debt and equity component).

Based on the figure above, we can classify funds into one of three types of impact funds:

- Small Specialist: small fund that only has an impact strategy and focusses on one or two themes
- Small Generalist: small fund that only has an impact strategy and focusses on three or more themes
- Large Generalist: large fund manager that has multiple strategies and focusses on three or more themes

Currently, we do not observe larger funds that focus on just one or two themes (that would classify as a 'large specialist'). Each type of impact fund has some distinct characteristics, as can be found in the table below.

[9] Phenix Capital 2022 Impact Fund Universe Report

Characteristic	Small Specialist	Small Generalist	Large Generalist
Fund size	< 1 billion (smallest: €30 million)	< 1 billion	> 1 billion (largest: $7 billion)
Number of investment themes	1 or 2	> 3	> 3
Fund strategy	Usually venture capital	VC/Growth/BO	Usually buyout
Track record	Usually limited	Often raised 1-3 impact funds before	Usually started an impact fund only recently, often re-labelling past deals as impact investments
Description of impact	Often lies in the future, potentially larger impact, mostly unproven but sometimes disruptive technologies	Usually the upscaling and go-to-market of companies / technologies that have proven to make impact	Expand market or add product lines for existing companies. Often clear and measurable impact KPI's but potentially lower impact
Quality of corporate governance	Low, often a small and growing organization	Medium	High, often a strong organization with professional functions in place
Quality of impact reporting	Medium	Medium	High, often well-documented
Probability of 'impact washing' *(reported ≠ actual impact)*	Low, often intrinsic motivation to make impact	Low, often intrinsic motivation to make impact	Medium, sometimes the reason is to gather assets and not intrinsic, often a 'famous' person is attracted
Target geographies	Usually only (Western) Europe, sometimes only one country	Usually Europe, though US fund managers are catching up	Usually worldwide, sometimes including emerging markets / Africa
EU SFDR classification*	Usually Article 9	Usually Article 9	Usually Article 9

*Sustainable Finance Disclosure Regulation from the European Union applies only to European funds

Although funds can have different characteristics in practice, this classification can offer guidance for investing in private equity impact funds. For example, investors that would like to contribute to the energy transition via start-ups and accept the higher investment risk are likely to invest with a small specialist. An investor finding it important to make impact on a diverse set of themes and geographies and invest with an established firm will likely end up with a large generalist.

The impact ecosystem

In addition to the growing number of impact funds, many initiatives have been launched to support and stimulate impact investments: from regulatory bodies, the sector itself and external organizations such as consultants that help impact funds to develop an impact (measurement) framework. The list below contains a few of these initiatives.

Laws and regulations

- EU: European Taxonomy, SFDR, EU ETS-system (CO_2-emission rights)
- US: Biden's 'Build Back Better' plans towards a greener economy
- Other: Paris Climate Agreement, Glasgow climate conference, national legislation and subsidies, Principles of Responsible Investment (United Nations)

Sector Initiatives

- International Finance Corporation's Operating Principles for Impact Management
- Global Impact Investing Network (GIIN) – *Aegon is a member since 2012*
- Impact Management Project (IMP) to set up impact KPI's and track them
- Phenix Capital Impact Summit Europe: annual conference in Amsterdam

Impact measurement and reporting

- Science-Based Targets initiative (launched during COP26) to scientifically measure the feasibility and progress of impact goals
- ILPA Data Convergence Project to harmonize ESG data across funds
- BlueMark independently verifies the impact claims of funds
- IRIS+ (initiated by the GIIN): system to measure and track impact KPI's

Research and data

- Consultants and placement agents increasingly publish reports on impact funds
- Phenix Capital Impact Database containing over 1.000 private equity impact funds
- Data providers with impact data and research: Preqin, Pitchbook, Cambridge

4. Selecting the right impact fund

When an investor wants to invest in an impact fund, the first question is: what impact do I want to make? Focusing on specific investment theme(s), SDGs or a type of impact fund (e.g. small specialist) allows for more deliberate choices. Note that when impact is defined too narrowly (e.g. 'sustainable fishery'), the long-list can become rather short. Other considerations include the different risk/return characteristics, whether the carried interest should be tied to certain impact KPI's, the preference for investing in a long-hold strategy and whether external parties are involved.

Is there a trade-off between impact and financial returns?

There is no clear answer to this question as impact investing has become more institutionalized only recently and researchers use different impact definitions. On the positive side, a study by the World Bank shows that a portfolio of impact investments outperformed the S&P500 by 15% between 1956 and 2019[10]. On the other hand, a study from the University of California shows that impact funds (median IRR of 6.4%) underperformed traditional funds (7.4%) using funds with vintage years between 1995 to 2014[11]. According to the Cambridge Impact Benchmark, the top quartile of 49 developed market funds had a net IRR of 12% over the period 1998-2019 against 2% for the bottom quartile[12]. As such, the answer to this question depends to a large extent on the impact funds that are selected.

The due diligence phase of selecting the impact fund that aligns best with an investor's goals and considerations requires a deep dive into the impact aspect. Apart from standard due diligence points (on the organization, legal terms, costs, etc.) and a list of excluded investments, the selection of impact funds requires additional impact selection criteria. Note that the list below is not exhaustive and additional selection criteria can be relevant for different (niche) impact funds.

Subject	Additional selection criteria	Explanation
Strategy	Motivation of starting an impact strategy	Are fund managers genuinely motivated or do they seek to bring in more fee revenue?
	Which investment themes are targeted?	Find out if the type of investments the fund targets aligns with the themes you want to target. Do you seek social impact, environmental impact, or a combination?
Team	Motivation of working for an impact fund	Look e.g., at the composition and experience of the deal team and the founder(s). In case well-known businesspeople or politicians are involved, find out why that is.
	Alignment financial incentives and impact	Does the carried interest that deal team members earn depend on impact objectives?
Risk	Assess the risk of impact washing	The risk is larger when firms over-report on the impact they claim to have.
	Assess the execution risk	Assess other investment options to achieve the same impact. Are there alternatives?
Track record	Relation between financial and impact returns	Look at historic impact investments. If investments with more impact have lower returns, how acceptable is that? Moreover, note that impact funds often have a limited track record available (especially small specialists). How comfortable are you with this?
Reporting	How is impact measured and reported?	Look at the extent, quality and accuracy of how impact is measured and reported on. Has the impact fund developed its own reporting framework, or did they hire external expertise for this? And how extensive and qualitative should the reporting be?

Ending note

Compared to a few years ago, private equity impact funds are now more institutionalized and the ecosystem around impact investing is professionalizing rapidly. Even though non-impact funds are increasingly incorporating ESG criteria into their investment process (including improved ESG reporting), impact funds go beyond this, through their thematic and purposeful approach, where social and environmental influence are at least as important as financial returns. Given the growing number of impact funds, selecting the best funds becomes increasingly important. Fund managers riding the impact bandwagon need to be distinguished from the true impact forces for good.

[10] *Long-run Returns to Impact Investing in Emerging Markets and Developing Economies*, World Bank Group, August 2020
[11] *Impact Investing*, University of California, December 2019
[12] Cambridge PE/VC Impact Benchmark, June 2020

Disclosures

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