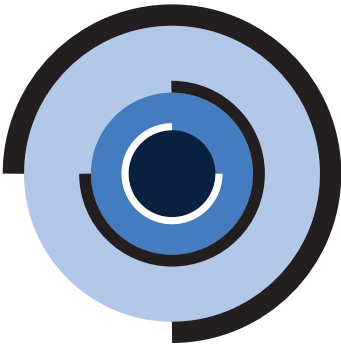
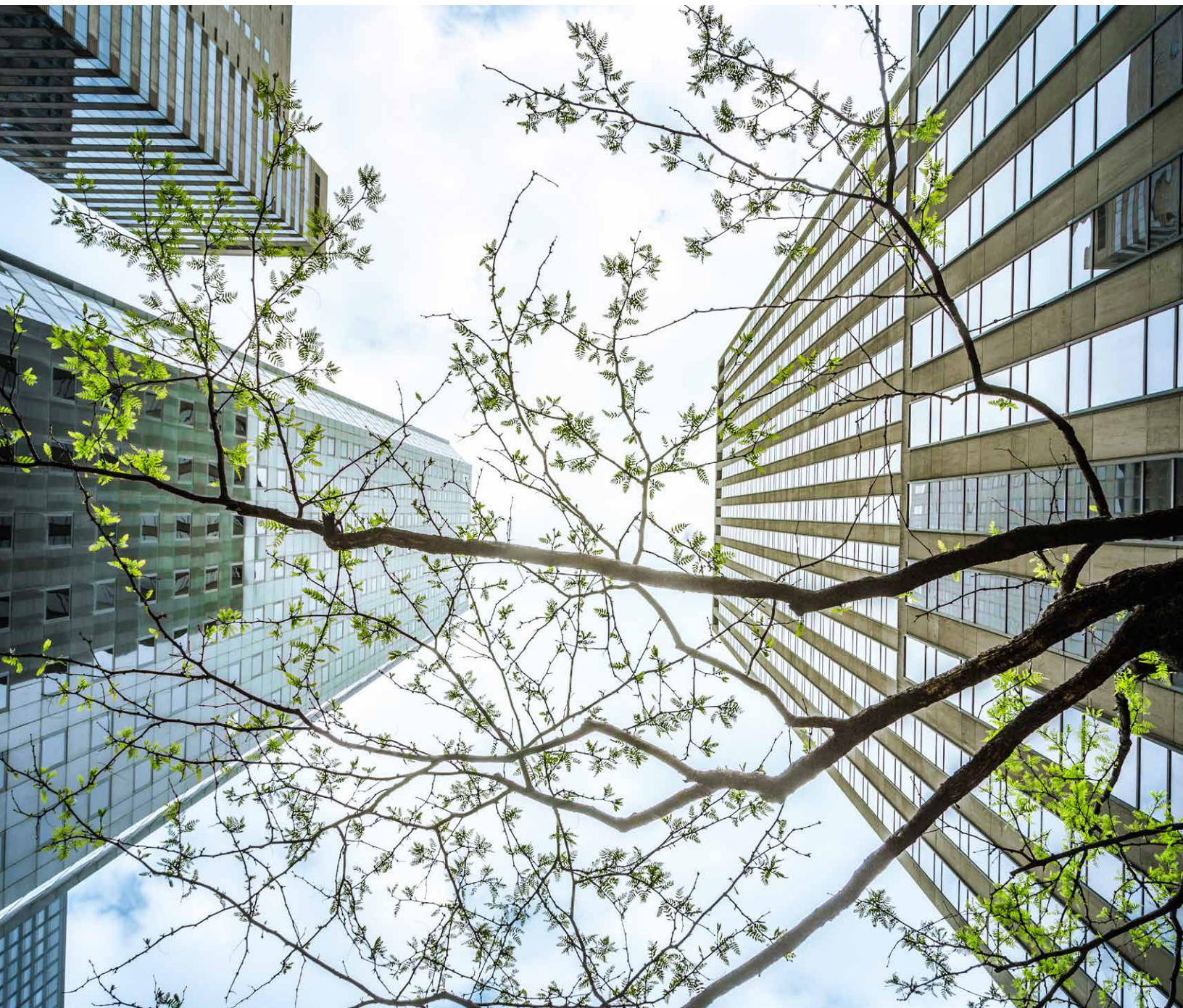


**PRIVATE EQUITY AND IMPACT INVESTING:**

A PRIMER FOR FAMILIES



**THE IMPACT**



The ImPact is a membership network of family enterprises (family offices, foundations, and businesses) that are committed to making investments with measurable social impact. The ImPact provides families with the knowledge and network they need to make more impact investments more effectively, and uses sophisticated technology for data aggregation, analysis, and reporting to shift the narrative of impact investing from one of inputs (dollars committed) to outcomes (impact created). Our purpose is to improve the probability and pace of solving social problems by increasing the flow of capital to investments generating measurable social impact.

# PRIVATE EQUITY AND IMPACT INVESTING:

## A PRIMER FOR FAMILIES

*Families can make private equity investments that help generate social and environmental impact at scale. By investing growth capital in fast-growing, intrinsically impactful businesses or by improving the social and environmental impact of mature operating businesses, private equity investors can generate commercial financial returns and address critical global challenges.*

*The purpose of this primer is to explore various private equity strategies families use to achieve their overall impact and financial objectives. This document is intended to be explanatory and not a source of investment advice.*

### Setting the stage

The generic term “private equity” includes a wide range of investment types. For the purposes of this primer, the term “private equity” refers to investments into mature (and not early-stage) operating companies. For an exploration of early-stage venture capital, please see our Early-Stage Impact Investing Primer.<sup>1</sup>

Family offices have significantly increased their investments in private equity since 2009.<sup>2</sup> As interest in private equity has increased among families, so too has consideration of the social and environmental impact of private equity investments. Some families are aligning their private equity allocation with their impact strategy by selecting among a limited but growing number of impact-oriented private equity funds. Families with extensive experience owning and operating mature companies may make direct private equity impact investments to complement their existing companies or to perpetuate their owner/operator investment strategy.

### Key Characteristics:

Despite the the variety of private equity investment strategies, most private equity investments share several key characteristics:

#### Focus on Profitability and Growth

Private equity investments are made into mature operating companies for the purpose of improving profitability and increasing growth. Private equity investors often improve the operating efficiency of their portfolio companies in order to reduce costs and raise productivity. Many private equity investors offer “growth capital” in order to assist a growing business over a financial hurdle so that it can scale more quickly and easily. Impact-oriented investors may focus their operational improvements on high-value environmental or social factors or provide growth equity to businesses whose core products or services create social and environmental benefit.

#### Participation Beyond the Dollar

Private equity impact investors often provide operational expertise, networks, and new strategies to a business in order to improve operations and drive growth. Investors with deep knowledge and experience can guide an impact enterprise’s expansion into a particular geography, improve its supply-chain management,

#### Private equity investments are

investments in private companies made to scale and/or improve the profitability of a business. Private equity also includes investments in public companies with the purpose of taking them private. Private equity is part of the “alternative investments” asset class. Private equity investment can offer:

- Impact at scale in a particular geography or sector
- An opportunity for an investor to contribute their own business acumen toward the expansion of a company
- Commercial financial returns

**Families can align their private equity investments with their values by strategically choosing in which private equity fund they invest.**

or connect company leadership with other mission-driven entrepreneurs.

### The Role of Debt

Some private equity investors use debt to provide additional capital for their investments and increase their potential investment return. Careful use of debt “leverage” can create opportunities for impact and profit at a scale beyond the capability of an investor’s equity capital alone. The tradeoff for this increased upside is increased financial and impact risk, and the fixed timeline of many private equity funds intensifies these risks. High debt loads can cause investors (and their appointed company executives) to take extreme cost-cutting measures within a portfolio company. These cost-cutting measures can include employee layoffs, reduced investment in worker training, and reduced investment in productive technologies (or other capital expenditures) that create short-term costs but long-term value.<sup>3</sup>

### Big Tickets, Long Time Horizons, and Illiquidity

Purchasing a major stake in an established operating company requires large amounts of capital. Since 2006, nearly 60 percent of private equity deals in the USA have involved transactions greater than \$25 million; these deals have accounted for more

than 95 percent of the total capital deployed by private equity funds.<sup>4</sup> Though private equity investors write far larger checks than do early-stage investors, private equity investments tend to be lower risk due to the maturity of the underlying companies. Like venture capital, though, investors in private equity funds must accept long fund periods (10 to 15 years) and manage around the illiquidity of their investment.

### Principle Motivations for Making Private Equity Impact Investments

#### Values Alignment

Families can align their private equity investments with their values by strategically choosing in which private equity fund they invest or in what ways they influence companies in which they directly invest. Families with a fixed allocation to private equity as part of their diversified investment strategy may target their investments towards funds whose sector focus, investment thesis, and operating model align with family values and impact objectives. Families that make direct investments in mature operating companies can shape the governance, operations, and culture of those companies to ensure values alignment.



## Social and Environmental Impact Drive Long-Term Outperformance

Impact and conventional investors alike recognize the financial risks and opportunities that social and environmental factors create. Investors seeking to capitalize on the business opportunities these factors create may target funds or companies dedicated to sustainable innovation in large, fast-growing, trillion-dollar sectors, such as energy, food, water, education or healthcare.<sup>5</sup> Investors who wish to protect themselves from the downside risks of social and environmental factors might select fund managers who are implementing targeted resource and brand management strategies in businesses across sectors.

## Using Business to Address Specific Social and Environmental Challenges

Private equity investors can help scale companies whose products or services address a critical social or environmental challenge. Families may view investments in industry-specific growth equity funds as natural complements to solutions-oriented, early-stage investing; as innovative companies mature out of venture capital portfolios they often seek private equity funding for subsequent stages of growth. Geographically focused private equity funds can also contribute to families' place-based impact investment strategies as the growth of small- and medium-sized enterprises can help drive inclusive economic growth.

## Private Equity Impact Investment Opportunities

### Intrinsically Impactful Businesses

Businesses that address resource scarcity challenges or meet essential human needs offer growing opportunities for investors to generate positive impact alongside financial return. Many impact investors are drawn to “intrinsically impactful” businesses addressing the problems of


clean energy production, sustainable food distribution, education access, healthcare quality, or access to fair financial services. Private equity can help businesses tackling big problems grow and achieve impact at scale. Elevar Equity, for example, invests growth equity into businesses that provide financial products for people in disconnected communities around the world. To date, Elevar has backed 24 companies, served over 18 million clients with over 18 essential services, and created 40,000 jobs.<sup>6</sup> In 22 of its investments, Elevar has served as the first institutional investor.

### Sustainable Operations

Many private equity investors pursue data-driven changes to the operations of their portfolio companies in order to create financial value. A growing number of private equity fund managers are incorporating the measurement and management of social and environmental factors within the operational changes they pursue. Sustainability improvements within otherwise conventional businesses can create social and environmental benefit while improving companies' bottom lines. For example, KKR, one of the world's largest conventional private equity managers, created a Green Portfolio Program to strategically measure and manage the environmental impacts of its portfolio companies. KKR's goal was to increase companies' efficiency, reduce operational costs, and improve their



**Private equity investors can help scale companies whose products or services address a critical social or environmental challenge.**



**Fund structures and timelines can be an important consideration for families making private equity impact investments.**

profitability.<sup>7</sup> In total, the Green Portfolio Program created over \$644 million in cost savings and added revenue; 3.4 million tons of waste prevented; 13.2 million cubic tons of water saved; and 1.2 million metric tons of greenhouse gas emissions avoided.<sup>8</sup>

### Geography

To date, investors with place-based impact strategies have driven a substantial portion of all impact-oriented private equity activity. Development finance institutions (DFIs) such as the International Finance Corporation (IFC) view private equity as a major tool for growing small and medium-sized enterprises (SMEs) that create inclusive economic growth in emerging and developing markets. A growing number of private funds dedicated to job creation and “base-of-the-pyramid” services are attracting investment from families. Sarona Asset Management, for example, manages a private equity fund of funds strategy, investing exclusively in frontier and emerging markets.<sup>9</sup> Sarona invests in private equity funds that, in turn, invest growth equity in SMEs within information technology, education, healthcare, financial services, and other sectors.

### Fund Structures and Timelines

Fund structures and timelines can be an important consideration for families making private equity impact investments. Most private equity investment vehicles are funds (limited partnerships) with a fixed 10 to 15 year timeline. Fund managers buy large stakes in businesses with the intention of selling those stakes within three to five years. In certain cases,

this timeline can be compatible with an impact investment strategy; a growth equity fund can, for example, provide a critical injection of capital needed for an impactful business to rapidly scale. Because the effect of the investment is meant to be short-term—the fund’s goal is to help the company overcome capital-dependent growth barriers, and not to overhaul core business operations—the fund can create both significant financial value and impact at scale within a limited timeframe.

In other cases, though, impact investors argue that a fixed-term fund structure can exert pressure on fund managers to act against the long-term viability and impact of their portfolio companies. In an effort to quickly extract value, investors may pursue cost-cutting measures with significant negative impact. Investors may also avoid making capital expenditures on product improvements or sustainability initiatives whose financial payoffs occur beyond the fund’s investment horizon. Impact investors also raise concerns about the “exit risk” inherent to many private equity fund strategies: an impact private equity fund that is obligated to sell its holdings at a certain time may have little choice but to sell to investors who do not intend to protect or grow the impact of a business.

In light of these concerns, some families are looking to alternative models through which to pursue their impact investment strategies. Holding companies are one model attracting increased interest from impact investors. Holding companies make long-term investments to hold and grow portfolio companies without a fixed exit requirement. Investors own shares of the holding company itself, and the holding company generates liquidity to shareholders through means other than the sale of an underlying company. Because of their open-ended timeline, holding companies can pursue performance improvements of businesses they own without arbitrary time pressure.

For impact investors, the long-term approach of a holding company investment may help better preserve the mission of a values-aligned business. The longer time horizon can also provide long-term approaches to sustainability measurement and management: optimizing energy efficiency, minimizing waste, or improving employment practices often take time before they offer returns on investment. As mission-driven companies grow beyond the venture capital stage, their owners and operators will seek growth equity from aligned investors. Simultaneous pressure from asset owners and entrepreneurs may drive an increase in holding companies and other alternative structures in coming years.<sup>10</sup>

### **Impact and Financial Considerations of Private Equity Investments**

Funds seeking commercial financial returns dominate the impact-oriented private equity landscape. There is limited data available on the performance of impact investment private equity funds. What data there is suggests that impact investors can achieve commercial return targets, but that manager selection and due diligence are essential to achieving market outperformance.<sup>11</sup> Beyond the limited data on self-identified impact fund returns, an abundance of trends point to increasing harmonization of impact measurement and management and financial success within the private equity industry.

Families pursuing values-aligned investment strategies may look for impact measures that send signals of values alignment. Families might specifically invest in GIIRs rated funds,<sup>12</sup> or funds that target fast-growing B Corps.<sup>13</sup> GIIRs ratings and B Corp certification require funds and companies to measure a broad array of factors related to their basic operations and the impact of their products

or services. For values-aligned investors, the signal sent by a fund's (or operating company's) consciousness of these factors might matter more than the specific measurements themselves. On the fund level, targeting mission-driven companies can be good business. According to polling data, 91 percent of individuals would shift their purchasing to a brand associated with a good cause given comparable price and quality;<sup>14</sup> 67 percent of people prefer to work for a socially responsible business;<sup>15</sup> and 55 percent of consumers indicated they would pay more for products from a company committed to a positive social or environmental impact—an increase of 10 percent in just the past three years.<sup>16</sup>

Investors seeking financial outperformance from companies' sustainability-related operational improvements may expect targeted measurement and management of social and environmental factors from their fund managers and underlying companies. Measurement and management of relevant environmental, social, and governance factors has a proven connection to improved financial performance. Across industries, companies that measure and report on sustainability factors claim stronger stakeholder relationships, improved customer customer and employee loyalty, and improved risk monitoring and mitigation.<sup>17</sup>

Investors looking to address a particular problem in the world—and those looking to capture the growth of problem-solving businesses—may rely on impact measures that indicate a company's ability to solve

**66**  
Across industries, companies that measure and report on sustainability factors claim stronger stakeholder relationships, improved customer customer and employee loyalty, and improved risk monitoring and mitigation.

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As mission-driven startups mature, entrepreneurs and early-stage impact investors will seek growth equity from private equity investors whose values, timeline, and incentive structure are aligned with the company’s sustainable growth.

its target problem. These targeted impact metrics can double as key performance indicators for business growth and risk management. For example, Leapfrog Investments, a private equity fund investing in financial services businesses in Africa and Asia, has created its own measurement framework that integrates operational and financial key performance indicators with governance indices benchmarked to global standards.<sup>18</sup>

### Going Forward

There are a number of trends that are shaping the private equity impact investing space that will encourage its growth in the coming years. Some of those trends include:

**Maturing mission-driven ventures will attract later-stage impact investment:** As mission-driven startups mature, entrepreneurs and early-stage impact investors will seek growth equity from private equity investors whose values, timeline, and incentive structure are aligned with the company’s sustainable growth.<sup>19</sup>

**Spending power of consumers in frontier and developing markets will continue to rise:** GDP growth in emerging and frontier markets was nearly double that of developed markets between 1990 and

2010.<sup>20</sup> The rise of the middle class in frontier and emerging market contexts will result in enormous growth in spending power; the top 17 economies in the group will add almost 2.6 billion people with middle or upper incomes.<sup>21</sup> Small- and medium- sized companies in these markets will need significant growth capital in order to capture the market opportunity of growing domestic demand.

**The market for intrinsically impactful businesses is expanding:** Renewable energy will become the biggest source of electricity growth by 2020.<sup>22</sup> The global expenditure on education is over \$1 trillion.<sup>23</sup> Healthcare spending globally is growing at 6 percent per year—faster than global GDP growth.<sup>24</sup> These growing, trillion dollar industries will offer impact investors increased opportunities to scale companies with significant financial and impact upside.

**Sustainable business practices will offer growing, demonstrable market edge over conventional competitors:** Conventional businesses that integrate sustainability into their operations are already seeing the benefits of those changes. In the short term, sustainability measures can lead to lower operational costs and higher revenues.<sup>25</sup> In the long term, strong social and environmental management practices can minimize risk and extend business longevity by minimizing its exposure to external forces in the natural and social environment.<sup>26</sup>





## APPENDIX A

### Example Investments

#### SARONA ASSET MANAGEMENT

ASSET CLASS	SECTOR	GEOGRAPHY	IMPACT STRATEGY	RETURN PROFILE
Public Equity	Education	Sub-Saharan Africa	<b>Product-Based</b>	<b>Market-Rate</b>
Fixed Income	Environmental Conservation	Middle East & North Africa	<b>People-Based</b>	Concessionary
<b>Private Equity</b>	Sustainable Consumer Products	Central & South America	<b>Place-Based</b>	Off-Market
Venture Capital	Housing & Community Development	Asia & Oceania	Process-Based	
Real Assets	Agriculture & Food	Eastern Europe & Russia	Behavior-Based	
Hedge Funds	Energy & Resource Efficiency	Western Europe	Model-Based	
Social Impact Bonds	Safety & Security	USA & Canada	ESG-Screened	
Cash	Healthcare & Wellness	<b>Emerging Markets</b>	SRI-Screened	
	Access to Finance	Developed Markets		
	Employment & Empowerment	Global		
	Base of Pyramid Services			
	Sustainable Infrastructure			
	<b>Diversified</b>			

Sarona manages private equity funds of funds focused on frontier and emerging markets. Sarona invests in private equity funds targeting small- to mid-market companies that provide goods and services for the growing middle class in emerging market countries.

#### ELEVAR EQUITY

ASSET CLASS	SECTOR	GEOGRAPHY	IMPACT STRATEGY	RETURN PROFILE
Public Equity	<b>Education</b>	Sub-Saharan Africa	Product-Based	<b>Market-Rate</b>
Fixed Income	Environmental Conservation	Middle East & North Africa	<b>People-Based</b>	Concessionary
<b>Private Equity</b>	Sustainable Consumer Products	Central & South America	Place-Based	Off-Market
Venture Capital	<b>Housing &amp; Community Development</b>	Asia & Oceania	Process-Based	
Real Assets	Agriculture & Food	Eastern Europe & Russia	Behavior-Based	
Hedge Funds	Energy & Resource Efficiency	Western Europe	Model-Based	
Social Impact Bonds	Safety & Security	USA & Canada	ESG-Screened	
Cash	<b>Healthcare &amp; Wellness</b>	<b>Emerging Markets</b>	SRI-Screened	
	<b>Access to Finance</b>	Developed Markets		
	Employment & Empowerment	Global		
	<b>Base of Pyramid Services</b>			
	Sustainable Infrastructure			
	Diversified			

Elevor is a private equity fund manager investing growth equity in businesses that provide goods and services to disconnected, low-income communities. Elevor provides equity capital to entrepreneurs who deliver market-based solutions for financial services, housing, education, and healthcare in emerging market contexts.

## HCAP PARTNERS

ASSET CLASS	SECTOR	GEOGRAPHY	IMPACT STRATEGY	RETURN PROFILE
Public Equity	Education	Sub-Saharan Africa	Product-Based	<b>Market-Rate</b>
Fixed Income	Environmental Conservation	Middle East & North Africa	<b>People-Based</b>	Concessionary
<b>Private Equity</b>	Sustainable Consumer Products	Central & South America	<b>Place-Based</b>	Off-Market
Venture Capital	Housing & Community Development	Asia & Oceania	Process-Based	
Real Assets	Agriculture & Food	Eastern Europe & Russia	Behavior-Based	
Hedge Funds	Energy & Resource Efficiency	Western Europe	Model-Based	
Social Impact Bonds	Safety & Security	<b>USA &amp; Canada</b>	ESG-Screened	
Cash	<b>Healthcare &amp; Wellness</b>	Emerging Markets	SRI-Screened	
	Access to Finance	Developed Markets		
	<b>Employment &amp; Empowerment</b>	Global		
	Base of Pyramid Services			
	Sustainable Infrastructure			
	Diversified			

HCAP Partners is a private equity fund manager that invests growth capital in lower-middle market companies in the Western United States. HCAP makes investments that help create job opportunities in underserved communities in order to support a more diverse workforce that includes more low- and middle- income individuals and families.



## APPENDIX B

### Glossary

**Exit:** Liquidation of holdings by an investor, usually by selling an asset to convert it into cash.

**Financial upside:** The potential financial gain that an investment can achieve under optimal conditions.

**Fixed-term fund:** In the context of private equity, a fixed-term fund is a limited partnership with a required timeline for raising capital, making investments, and returning capital to limited partners. Fund timelines are established in fund's limited partnership agreement, and often include options for short-term extensions beyond the original end date of the fund.

**Growth capital:** Growth capital (or growth equity) is typically a minority private equity investment in a relatively mature company. The investment of growth capital is used to help expand operations, enter different markets, or finance a significant purchase without changing the control of the business.

**Inclusive economic growth:** Economic growth that benefits all segments of society.

**Leverage:** The use of debt (or other financial instruments) to increase an investment's potential return on equity. Private equity funds often make investments using debt. An investment made with significantly more debt than equity is considered highly leveraged.

**Risk:** The chance that an investment's financial return will be different than what was expected. Risk includes the possibility of losing some or all of the value of the original investment.

### Endnotes

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<sup>4</sup> Pitch Book, "U.S. PE Breakdown 1Q 2016," 2016. [https://files.pitchbook.com/pdf/1Q\\_2016\\_U.S.\\_PE\\_Breakdown.pdf](https://files.pitchbook.com/pdf/1Q_2016_U.S._PE_Breakdown.pdf).

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<sup>6</sup> To read more about Elevar Equity, see their website: <http://elevarequity.com/about-elevar/>.

<sup>7</sup> To learn more about KKR's Green Portfolio Program, see: <http://www.slideshare.net/mariahsharp712/kkr-creating-sustainable-value>.

<sup>8</sup> See slide #29: <http://www.slideshare.net/mariahsharp712/kkr-creating-sustainable-value>.

<sup>9</sup> To learn more about Sarona Asset Management, see: <http://www.saronafund.com/frontier-emerging-markets/>.

- <sup>10</sup> Alignment Holdings is an exemplifies the growing interest in holding company structures among impact investors. To learn more, see: <http://www.collaborativefund.com/about/alignment-holdings/>.
- <sup>11</sup> Cambridge Associates and the Global Impact Investing Network, “Introducing the Impact Investing Benchmark,” 2015. The ImPact also referred to this study in the Early Stage Impact Investing Primer. Note that this study included private equity funds that invested at business stages, including venture capital as well as growth equity and middle-market. It did not include buyout funds.  
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- <sup>12</sup> To learn more about GIIRS ratings, see: <http://b-analytics.net/giirs-ratings>.
- <sup>13</sup> To learn more about B Corps, see: <https://www.bcorporation.net/>
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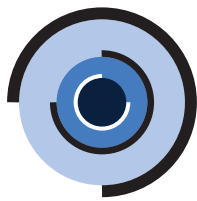
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