

Pension Pulse

Daily Insights on Pensions and Financial Markets

Impact Measurement in Private Equity

By [Leo Kolivakis](#) March 11, 2020



Jim Totty and Richard Burrett of [Earth Capital](#) sent me a very interesting paper they wrote, *Impact Measurement in Private Equity – Cutting through the Complexity*.

As global capital markets embrace the urgent need for impact investing, private equity is at the forefront of this dramatic change. However, there is currently a wide range of bespoke approaches to impact measurement, and the lack of standard methodologies in private equity is hindering capital inflows. In this article, we set out a straightforward framework for impact measurement in the private markets.

At [Earth Capital](#), we believe a ‘whole life’ scorecard is the approach that delivers consistent and robust impact measurement in private markets. It is easy and quick to implement and allows comparison and aggregation across portfolios.

Dramatic Market Growth in Impact Investing

There has been a rapid increase in impact investing in recent years. At the end of 2018, Morgan Stanley Wealth Management commented that 84% of investors say they are interested in impact investing or putting their money behind companies that make a positive difference in the world. In April 2019 the Global Impact Investing Network (GIIN) assessed the current size of the global impact investing market to be \$502 billion. Nonetheless, this still remains a small subset of ESG integration and responsible investment. The Principles for Responsible Investment membership represents assets under management in excess of \$80 trillion. A key question is whether a simple framework for impact and its measurement is needed to promote



positive impact investing, as opposed to investment that is merely doing 'less harm' through ESG integration.

Key Differences between Impact Investing and ESG Integration

Both the agreement of climate goals in the Paris Agreement in December 2015, and the broader delivery of the 17 UN Sustainable Development Goals (SDGs) from earlier that year, have done much to increase the flow of capital into the low carbon, sustainable and 'just' economy, particularly galvanising new investor focus in impact investing. With this impetus has come a clear recognition of the distinction between traditional ESG integration and the new impact investing market.

Impact investing involves making investments with the conscious 'forwards looking' intention to generate positive, measurable, social and environmental impact, alongside a financial return. This goes beyond environmental, social and governance (ESG) integration which is only a 'backwards-looking' reporting of ESG performance, and which may still permit investment in industries that can have negative environmental and social outcomes. In contrast, impact investing looks to anticipate future societal and environmental needs and deliver positive returns for people, planet and profit.

An ESG integration strategy identifies companies in a sector that perform better than peers in ESG metrics, and implements tilts, exclusions, or active engagement to weight and improve portfolios' ESG performance. **If this is not combined with some form of exclusion-based screening, it may leave portfolios with significant residual exposure to a range of fossil fuel-intensive industries, or sectors such as tobacco.** An impact investing strategy, on the other hand, takes concrete action by investing in 'pureplay' investments focussed on actionable positive environmental and social outcomes. Both strategies seek to improve outcomes, but impact investing allows investors to make more focused and measurable contributions. ESG is often seen as changing finance, but only impact investing is consciously financing change.

Why Private Equity is the key to Impact Investing

ESG integration in large-cap listed equity and fixed income tends to focus on larger long-established businesses with significant inertia and long capex cycles. Although ESG data is becoming available, improvements in environmental and social performance may be slow, long term projects. In contrast, Private Equity, unlike these other asset classes, is the best approach for impact investing by giving exposure to 'pureplay' sustainable business models in technology and services. These offer transformational environmental and social impact from the outset, with fast moving business models and nimble market penetration.

Impact Measurement in Private Equity – the story so far

A successful impact strategy must include robust measurement, and to date, most private equity GP's have evolved their own measurement methodologies, either entirely in-house or with the help of sustainability consultancies. **Unfortunately, this wide range of bespoke methodologies is not helpful to capital markets which seek standardisation. For both LPs and investee companies, significant time**



has to be invested in educating, explaining and implementing each GP's approach. Further impact measurement shortcomings can include unclear objectives, poor data collection and analysis, inconsistent reporting and a lack of clear standards for what qualifies as an impact investment.

The urgency to exploit the investment opportunities in impact investing means that confusion over standards must not be allowed to impede inflows of capital. The current wide number of bespoke approaches now needs to coalesce rapidly around a small number of consistent and understandable impact measurement standards. This pressure is analogous to the development of accounting standards from the 1930s onwards in response to events such as the 1929 stock market crash. Although there may be longer-term improvements of impact standards in parallel, there is no time to wait for this to make investments.

We cannot let the 'perfect' be the enemy of the 'good', time is pressing to make impact investments.

Cutting through the Complexity in Private Equity Impact Measurement

We have reviewed the approaches currently used by private equity funds and have identified key themes that characterise different approaches taken. These are set out in Figure 1 below, 'Impact Measurement in Private Equity – Cutting through the Complexity', which is defined by two key questions for an impact measurement approach in private equity

1. Do you attempt to measure all investments with the same set of consistent whole life measures and data sets, or do you select bespoke sets for each situation?
2. Do you do 'deep dive' 'vertical' quantitative analysis, or do you apply a shallower 'horizontal' scorecard approach?

FIGURE 1. IMPACT MEASUREMENT IN PRIVATE EQUITY - CUTTING THROUGH THE COMPLEXITY

	Deep dive vertical quantitative analysis	Horizontal scorecard analysis
Consistent (whole-life) total impact parameters	<p>Quant impact Quantitative impact-driven analytic assessment across a range of impacts.</p> <p>Pros: Can provide rich analytic insight and describe linkage to financial performance.</p> <p>Cons: Requires data-rich, well-parameterised datasets more readily found for large-cap listed equities.</p>	<p>Whole life impact scorecard Holistic measurement.</p> <p>Pros: Allows comparison across all investments in a portfolio and is not onerous to implement for management teams, avoids survey fatigue, consistency allows for aggregation at fund and fund manager level.</p> <p>Cons: Not intended to deliver a deep quantitative assessment but this can be completed where it is of value.</p>
Selective choice of impact parameters	<p>Impact return on investment Quantification of impact in monetary terms such as an impact multiple of money invested.</p> <p>Pros: Neat parameterisation in monetary terms makes it easy to understand.</p> <p>Cons: May require changes in methodology for each investment. Limited ability to make comparisons across different investments. Can be laborious and hard to audit. Calculations are only as good as the data that feeds them. May not include 'whole life' impacts of a business other than local measures. There may be limited reporting on negative impacts.</p>	<p>Mission alignment and measurement Selective bespoke KPIs are identified for each investment to align between mission and measurement.</p> <p>Pros: Straightforward to implement by choosing easy to measure KPIs for a given investment.</p> <p>Cons: Tendency not to choose the harder to measure metrics, and report only positive impact and not negative. May not include supply chain and end of life impacts. Limited ability to make comparisons across different investments as metrics may differ, hampering the ability to aggregate at fund and fund manager level.</p>

Source: Earth Capital, March 2020

Although the 'Quant Impact' approach is normally only used for listed equity strategies, the other three methodologies are in current use in impact private equity.

Quantitative analysis such as the 'impact return on investment' can neatly parameterise in dollar terms, but it is only as good as the data it is fed and can be complex to implement and hard to audit. If data is poorly parameterised or incomplete, its analysis risks becoming spurious. Whilst the advent of blockchain or "big data" approaches may assist in these approaches, this remains a future development for private equity.

Selective 'Self-certified' choices of KPI's bespoke to each investment are appealing from an ease of adoption perspective but have significant drawbacks. These 'mission alignment and measurement' scorecards may choose only metrics that are easily measurable and look good. This can go hand in hand with a tendency to only report positive impact and avoid negative impact. It is especially vital to include supply chain and end of life impacts in measurement. The 2017 GIIN survey 'The State of Impact Measurement and Management Practice' revealed that two-thirds of the impact investment industry



only report positive impact, and only 18% measure negative and/or net impact for all of their investments. Even if this is addressed, bespoke KPIs will limit the ability to make a comparison of impact across different investments or to consolidate at fund and fund manager level.

There are several further approaches used in impact investing.

- Social impact measurement often uses ‘Theory of Change’ models, however in a ‘live’ investment environment, the goal setting and measurement this involves is effectively the same as the mission alignment and measurement selective scorecard above, i.e. identify KPI’s bespoke to each investment and then measure against them.
- Control Groups are an academic approach to compare investment outcomes against a randomised control group. This can be challenging to implement in many real-world impact investment situations as a duplicate potential investment has to be identified and then kept ‘uninvested’ and measured for the lifetime of the actual investment.
- Additionality is also studied in impact investing but its quantification in real investment situations has to be through either
 - ‘Full measurement’ approaches which require control groups with the inherent difficulties explained above or
 - a KPI scorecard ‘low, medium or high’ which is a subset of the KPI’s in the ‘mission alignment and measurement’ discussed above.
- SDG based labelling of impact strategies can be used for high-level sector mapping, **but the SDG’s do not lend themselves easily to quantitative holistic impact measurement. They can, nonetheless, help to define impact metrics for specific target areas.**

At Earth Capital, we believe a ‘whole life’ scorecard is the approach that delivers consistent and robust impact measurement in private markets. Key performance indicators are selected across environmental, social and governance tests. The scorecard is easy to implement and is not onerous to complete with portfolio companies. Start of life and end of life impacts are included, and negative impacts are considered and measured. The ‘whole-life’ scorecard allows portfolio company improvement to be measured over time, comparisons can be made between investments, and it allows aggregation at both the fund and fund manager level.

Market Developments

Impact Investing methodologies will continue to evolve for many years to come, with ongoing improvements in the choice and range of metrics in impact scorecards. The IFC’s Impact Management Framework and the Impact Management Project are invaluable initiatives in this evolution process.

What is clear however is that the global urgency of environmental and social needs means that impact investment must press ahead at speed. The simple measurement approaches set out in this article provide the measurement framework to enable this. Private market asset owners and asset managers will benefit from quick and straightforward impact approaches across both existing portfolios and new investments.



Conclusions

Impact investing is growing rapidly in response to rising demand for strategies that go beyond ESG integration to produce measurable societal benefits and support a transition to low carbon and sustainable and just economy. Private equity is at the forefront of this transition. **The ability to effectively measure and manage desired impacts is critical to ensuring that impact investments fulfil their stated objectives. Reliable metrics are needed to avoid the potential risk of “impact washing,” and using the ‘impact’ label primarily for marketing and asset gathering purposes. Impact measurement and management should be embedded in all phases of the investment process, from initial due diligence and project selection to investee company performance management and reporting.**

Quantitative analysis such as the ‘impact return on investment’ can neatly parameterise in dollar terms, however, it is only as good as the data it is fed and can be complex to implement. Although this lends itself to large-cap public market securities where high-quality market data might support robust ‘quant’ analysis, it will remain challenging to implement this in the private equity space.

Selective ‘self-certified’ ‘mission alignment and measurement’ choices of KPI’s bespoke to each investment are appealing from an ease of adoption perspective but currently tend to only report positive not negative impact and ignore whole-life impacts. They limit the ability to make a comparison of impact across different investments or to consolidate at fund and fund manager level.

As a result, we believe a ‘whole life’ scorecard is the approach that delivers consistent and robust impact measurement in private markets. It is easy to implement, and allows comparison and aggregation across portfolios.

About Earth Capital

Earth Capital, a pioneer in impact investing since 2008, is a growth capital private equity investment manager totally focused toward Sustainability - investing capital into sustainable technologies for resource efficiencies and renewable clean energy infrastructure opportunities. We invest globally in companies and infrastructure which address the challenges of Sustainable Development, such as climate change, energy, food and water security. We focus on the commercialisation and deployment of proven, sustainable technologies, in various industries including agriculture, clean industry, energy generation, resource and energy efficiency, waste and water.

Our [Earth Dividend](#)[™] impact measurement methodology is a **‘whole life’ scorecard** developed for the private markets, based upon net Environmental, Social and Governance (ESG) impacts and benefits. The Earth Dividend[™] provides an annual measure of an investment’s Sustainable Development impact. It has been developed by Earth Capital’s in-house Sustainable Development specialists following review of international best practice approaches to the assessment, reporting and assurance of ESG issues and performance.



The [Earth Dividend™](#) is established as part of the due diligence process and reported annually. Our Sustainability team works to identify improvements in each area where they add value and make commercial sense. The plan targets annual improvements in the investment's contribution to sustainable development to enhance the underlying commercial performance of the asset and help to maximise value on exit. **The Earth Dividend™ enables a holistic understanding of the risk and impact of Sustainable Development; an understanding of where investments make a positive or negative impact; identifies those areas where a business may be made more resilient and from where more value can be extracted; and is subject to external assurance annually.**

Earlier this week, I had a chance to speak with Jim Totty and Richard Burrett of [Earth Capital](#) and go over their findings.

Jim started off by telling me:

"There's a lot of complexity in impact measurement and people are telling us we need to cut through it and get on with it. LPs are looking for a straightforward framework and something easy to implement. GPs have their own methodology which is bespoke and incomplete. There's a need to coalesce around one methodology."

I asked him what about regulators and he replied: "If we wait for regulators, we will wait for another six years."

He told me LPS "are well aware" of the limitations of the quant approach and there is "widespread scepticism".

As far as KPIs, he said "you can't compare apples to oranges" and "2/3 of methodologies are only measuring positive impacts" and are therefore incomplete.

He added: "there are many supply chain/ end of life issues" not being factored and that "most approaches are incredibly subjective, there's no consistency."

Richard reiterated many of these points, emphasizing the need for a more "holistic" approach. "We live in an integrated world; we can't just measure positive impacts".

They said they're receiving favorable feedback on their paper and approach and shared this with me after we spoke:

The key points we want to get across:

- **ESG changes finance but impact investing finances change.**
- As global capital markets embrace the urgent need for impact investing, private equity is at the forefront of this dramatic change. However, there is currently a wide range of bespoke approaches to impact measurement, and the lack of standard methodologies in private equity is hindering capital inflows.
- **Two-thirds of fund managers only measure positive impacts according to GIIN, and bespoke choices of impact KPI's tend to miss supply chain and end of life issues, as well as not allowing comparison between investments**



- Highly analytic impact measurement is only as good as the data you feed it and in the private markets is rarely justified – scorecards are much better
- **LPs and GPs are frustrated by the situation where every asset manager has their own impact measurement methodology, the market now needs to come together around a small number of straightforward and rigorous impact measurement approaches such as the Earth Dividend™.**
- **The Earth Dividend™ ‘whole life’ impact scorecard delivers consistent and robust impact measurement in private markets. The global urgency of environmental and social needs means that impact investment must press ahead at speed.**

For example, the Propelair air-assisted flush toilet saves 80-85% of the water consumption of a traditional flush toilet. Customers are buying Propelair due to both short payback periods, reduced spreading of viruses, post-flush energy savings and severe water shortages in markets such as South Africa. **However, even a strongly performing product still has room for improvement. The Earth Dividend™ scorecard highlights the potential to improve the toilet’s ceramics and plastics supply chain and allows us to work with the management team in introducing new sustainable ceramics or alternative materials.** Therefore, by using a holistic measurement tool it enables us to improve the positive impact of an investment, and also enhance the financial value at the same time.

Another example, electric vehicles bring immense benefits with their reductions in CO2, particulates and noise. **However, the lithium and cobalt in the batteries have often had a disastrous start in life with mining in the DRC and South America having extremely negative environmental and social impacts. Two-thirds of managers in the recent GIIN survey reported that they only measure positive impacts, and electric vehicles highlight the need to assess the impact of the whole life of a product, from cradle to grave. The effectiveness of their carbon footprint also depends on the electricity that powers them and end of life disposal. Those managers who only measure a few bespoke impact KPI’s for each investment will often fail to capture the start of life and end of life impacts.** The Earth Dividend ‘whole life’ impact scorecard delivers consistent and robust impact measurement in private markets.

I thank Jim Totty and Richard Burrett of [Earth Capital](#) for sharing their insights with my readers. I also thank Gordon Power, cofounder and CIO, for bringing this paper to my attention and putting me in touch with Jim and Richard, both of which are extremely knowledgeable on impact investing, as is Gordon.

There is a lot of fluff out there in the ESG landscape, very few private equity funds have the long track record, experience and knowledge of [Earth Capital](#) and its principals who are true experts on impact investing.

I strongly recommend my readers acquaint themselves with the fund and [Earth Dividend™](#) impact measurement methodology.

Lastly, I want to congratulate Earth Capital for winning an award for Most Innovative ESG Product at the ESG Investing Awards 2020:



We are pleased to announce that we have won the award for Most Innovative ESG Product for the Earth Dividend™ at this year's ESG Investing Awards.

The decision was made by a panel of experts in sustainable finance from top academic institutions and financial sector leaders.

The Earth Dividend™ is a measurement of an investment's sustainable development impact and is based on international best practice, mapped to the United Nations' Sustainable Development Goals. Considering the entire supply chain, it forms a key part of our due diligence process and is reported annually for each of our investments.

Our co-founder and Chief Executive, Gordon Power, said: "This award recognises the importance of an effective and transparent approach to measuring the impact of investments. **We hope that the Earth Dividend™ will continue to spearhead the industry towards more meaningful sustainable investment that has a genuine impact.**"

Our Chief Sustainability Officer, Richard Burrett, said: "We are delighted to win the award for the Most Innovative ESG Product. **We believe that deeper ESG integration is critical across the whole investment cycle. Our Earth Dividend™ tool enhances our due diligence, investee performance management and reporting; adding value across the investment process.**"

Well done, I posted a picture of the Earth Capital team above and also commend them for sharing their knowledge with the broader investment community.

Below, Earth Capital's Chief Sustainability Officer, Richard Burrett, and Director of Investment, Jim Totty, [discuss](#) their impact measurement approach in an interview for CISI TV.

