GLOBAL INSIGHTS

FROM IMPACT INVESTING TO INVESTING FOR IMPACT

By Jason M. Thomas and Megan Starr

The dual purpose of "impact investing" has always seemed to imply that positive social and environmental outcomes necessarily come at the expense of financial performance. In this paper, we document that it is precisely the societal goals of the impact investor – diversity and inclusion, environmental sustainability, responsible governance – that increasingly generate the above-market returns sought by the market as a whole. As traditional financial efficiencies have become more fully integrated and priced in to assets, environmental and social factors provide a lens to identify untapped value in all types of companies by driving sales, reducing costs and boosting productivity through improved governance, inclusion and diversity initiatives, workplace investments in human capital, and investments in energy sustainability.

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The phrase "impact investing" was coined in 2007 to describe a new form of financial intermediation that combines social and environmental mission-orientation with traditional asset management.[1] From the outset, the dual purpose of the strategy seemed to suggest that positive social and environmental outcomes *necessarily* come at the expense of financial performance. Researchers focused on impact's "cost" in terms of foregone returns,[2] often implying that traditional strategies must involve some degree of social or environmental degradation. As initially conceived, impact investing seemed predicated on a "damned if you do, damned if you don't" mindset that treats genuine impact as irreconcilable with (risk-adjusted) return maximization.

N.B. impact investing traditionally refers to private investments made into companies or assets with the intention to generate social and environmental impact alongside a financial return. ESG integration strategies are applicable across both public and private markets, and typically refer to the incorporation of environmental, social, and governance factors into a traditional investment analysis across a wide range of companies. Most institutional investors focus on where ESG factors add material value through differentiated insights (however other types of investors use these tools to express market views or personal priorities).

As markets have evolved, this stark dichotomization between social and financial returns has become progressively harder to defend.[3] The same companies often receive financing from both traditional asset managers and dedicated impact funds. The same pools of capital often commingle funds from highly-motivated environmental, social and governance (ESG) investors with those of investors focused solely on earning the highest possible (risk-adjusted) return.

More consequentially, as we describe in greater detail below, it is precisely the societal goals of the impact investor – diversity and inclusion, environmental sustainability, responsible governance – that increasingly generate the above-market returns sought by the market as a whole. As traditional financial efficiencies have become more fully integrated and priced in to assets, environmental and social factors provide a lens to identify untapped value in all types of companies by providing means to drive sales, reduce costs, enhance productivity, or expand valuation multiples.

The assumed trade-off between social benefits and financial returns may not just be outmoded; such thinking could actually impede improvements in investment performance. By presuming that social benefits detract from returns, traditional investors ignore the ways an impact orientation can add (market) value. And by assuming that genuine impact requires some degree of financial sacrifice,[4] impact investors can fail to appreciate how socially-optimal strategies manifest themselves in company income statements and valuations.

Improved Governance & Longer-Term Orientation

Relative to listed equities, private markets are illiquid, involve more concentrated ownership stakes, and offer investors a much greater degree of control over the underlying portfolio companies. These features naturally cultivate a longer-term orientation and a much broader assessment of risks and opportunities. Investors exchange liquidity for influence, a trade-off that could only make sense if the returns to more active governance compensate for the costs of being "locked in" to the investment. Since these returns typically take years to manifest themselves, private holding periods tend to be much longer than those of the typical stock market investor,[5] and require a willingness to hold the asset for five or more years.

As interest rates have declined and entry multiples have risen, it is no longer possible to generate historic rates of return without investing for impact – to use the term in a very broad sense. With no tailwinds from falling finance costs, recovering economies, or rising valuations, private markets investors can only meet return targets by consistently building better businesses. And while better businesses tend to be stronger financial performers, company financials provide much too narrow a vantage point to assess the strength or sustainability of a business. A much broader lens is required, which examines *every* component of the business through a total improvement orientation that adopts aspects of the intent, actions, and theory of change once thought to be the exclusive province of "impact" funds.[6]

Impact investors seek to produce beneficial social outcomes that would not occur but for their investment in an enterprise.[7] While "impact" funds in their purest definition are limited to investing in companies whose sole, or "core," business directly addresses a defined set of environmental or social challenges, a total improvement orientation assesses the potential actions to improve social and environmental outcomes at ***all prospective businesses***. Hence while

1 Höchstädter, A. and B. Scheck. (2015), "What's in a Name: An Analysis of Impact Investing Understandings by Academics and Practitioners," *Journal of Business Ethics*.
2 Barber, B. et al. (2019), "Impact Investing," NBER Working Paper No. 26582.
3 Chowdhry, B. et al. (2019), "Investing for Impact," *Review of Financial Studies*.

4 Brest P. and K. Born (2013), "When Can Impact Investing Create Real Impact," *Stanford Social Innovation Review*.
5 Morningstar estimates that the average turnover ratio for managed domestic stock funds is 63%, as of Feb. 28, 2019.
6 Jackson, E. (2013), "Interrogating the Theory of Change: Evaluating Impact Investing Where it Matters Most," *Journal of Sustainable Finance & Investment*.
7 Brest and Born (2013).

impact investing channels capital to a narrowly defined subset of potential investment opportunities, private markets' particular characteristics – concentration, control, and a longer time horizon – provide both the opportunities and financial incentives for investors to generate beneficial outcomes across a much broader universe of businesses.

From Cost Containment to Top-Line Growth

In the early years, private markets resembled a "barbell" with capital focused on early-stage venture and late-stage public-to-private delistings. Most of these late-stage investments targeted public companies that had squandered resources on dubious investments that seemed to prioritize size and maximize the resources under management's control (often referred to as "empire building").[8] Private governance more closely scrutinized the cost structures, product lines, and organizational hierarchies that evaded detection under the ownership of a broadly diffused mass of public shareholders free to sell their stake at any time.[9] While delivering significant increases in productivity, such scrutiny also often resulted in payroll reductions and it is, perhaps, these experiences more than any other that have contributed to the sense that financial returns and social returns do not coincide in traditional private investing.[10]

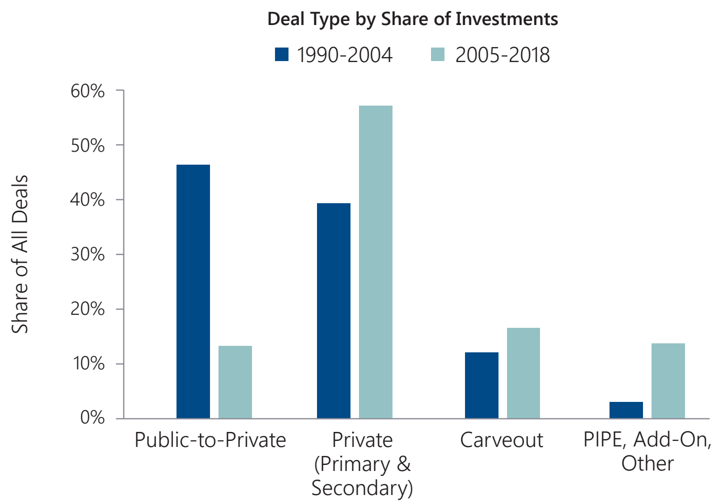
> "It is precisely the societal goals of the impact investor – diversity and inclusion, environmental sustainability, responsible governance – that increasingly generate the above-market returns sought by the market as a whole."

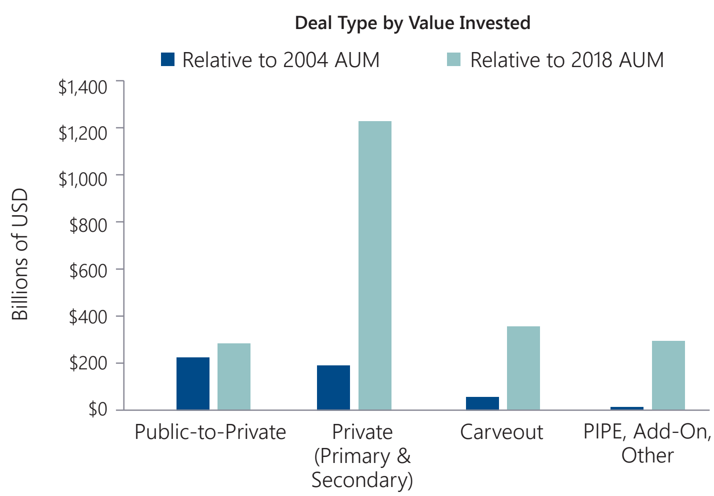
While discussions about the impact of private equity still focus on these public-to-private de-listings, these investments have declined significantly as a share of private market activity. The success of private governance – and the evidence of gross inefficiencies it uncovered – led to both a sharp decline in the number of public companies – from nearly 8,000 in the late-1990s to less than 3,500 today – and improvements in public company governance.[11] As a result, the market opportunity from public-to-private cost rationalization has declined precipitously and returns have come to depend on investors' ability to underwrite – and deliver – value creation from top-line growth.

Since 2004, investments in private companies – including secondary buyouts – have accounted for more than 60% of the $1.7 trillion increase in private markets assets under management (AUM) as delistings have waned in significance (Figure 1). With virtually no fat to cut, returns on these investments depend on investors' ability to catalyze growth, which typically results in substantial increases in employment.[12]

FIGURE 1

Changing Nature of Private Investment Types, 1990-2018[13]





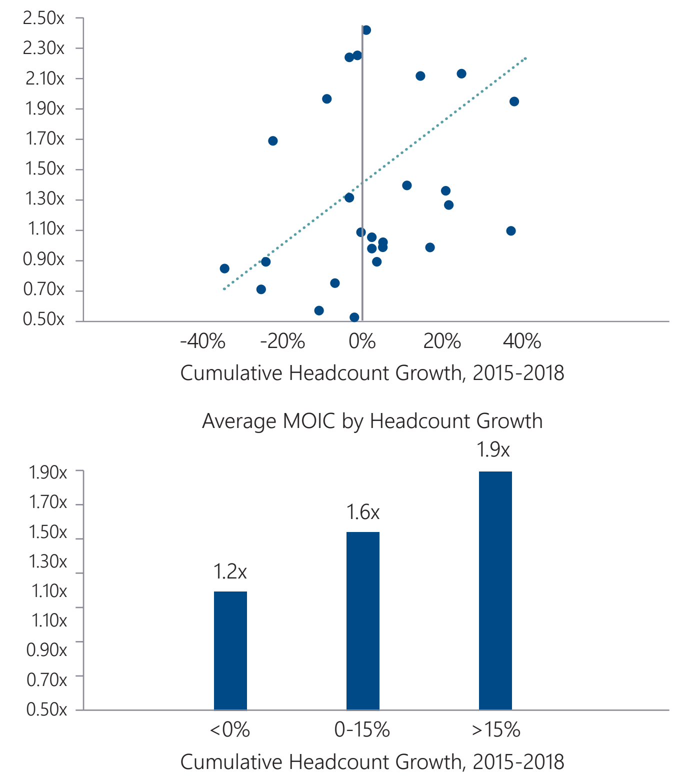
The alignment between financial and social returns is evident in the data. Among all U.S. Carlyle investments completed since 2013, every 10% increase in payrolls (excluding the effects of mergers) has been associated with a statistically and economically significant 21.4% increase in cumulative returns (likewise, every 10% decline in payrolls corresponds to a -21.4% drop in returns).[14] Among investments where employment growth exceeded 15%, average returns were nearly 60% higher than for investments where headcount declined, on average (Figure 2).

8 Jensen, M.C. (1986), "Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review.*
9 Richardson, S. (2006), "Over-investment of Free Cash Flow," *Review of Accounting Studies.*
10 Davis, S. et al. (2019), "The Economic Effects of Private Equity Buyouts," October 7, 2019.
11 Business Roundtable, 1997 Statement on Corporate Governance, affirmed that CEO's "paramount duty" is to the corporation's shareholders.
12 Davis, et al. (2019). Investments in private companies are associated with a 13% increase in employment, on average, over a two-year period. If the private company was previously owned by a private investor, the average employment gains are 10%, on average.
13 Josh Lerner, Harvard Business School, Global Preqin Data, June 2019, Carlyle Analysis of Portfolio Data.
14 This is based on a sample of 35 companies with at least 3 years' worth of headcount data over the period 2015-2018, controlled for anomalous growth (e.g., apparent acquisitions/divestitures, very low headcount, etc.).

We do not believe such employment growth was accidental or incidental, but stems directly from investor intervention: industry and product market expertise, and the doors opened and strategic guidance provided by professional networks and a global footprint. While few of these portfolio companies would meet the screen of a "pure" impact fund, the beneficial social outcomes would not have occurred in the absence of investment – here, value creation is demonstrably positively correlated with increased social value in the form of new jobs.

FIGURE 2

Positive Relationship Between Carlyle Payroll Growth and Returns[15]



Human Capital and Returns

Arithmetically, increasing payrolls does nothing to boost financial returns in and of itself. It is only when marginal sales grow at a faster rate than marginal employment that firm-level productivity increases at the rate necessary to hit return targets. While "human capital" often refers to the managerial talent and professional networks of people at the top of an organization, research and experience indicate that the experiential knowledge and motivation of the broad employee base is equally as important to company performance.

Firms with lower employee turnover dramatically outperform their high turnover counterparts (Figure 3), as the frictional costs of hiring and retraining more than offset any perceived gains from "holding the line" on compensation. Moreover, survey data also make clear that employee engagement reliably predicts productivity and profitability at the individual firm and business unit level (Figure 4). Our experience suggests that workforce investments that lead to positive social outcomes – higher retention rates, enhanced employee engagement, and greater sense of purpose – tend to yield financial returns not evident to observers solely focused on accounting data.

FIGURE 3

Workplace Investments in Employee Retention Generate Outsized Returns[16]

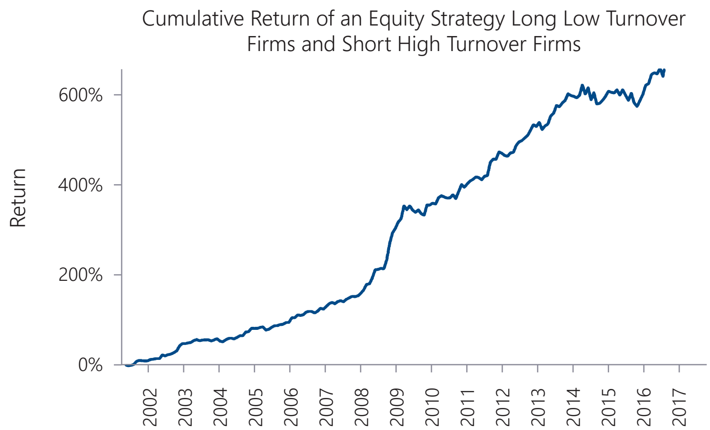
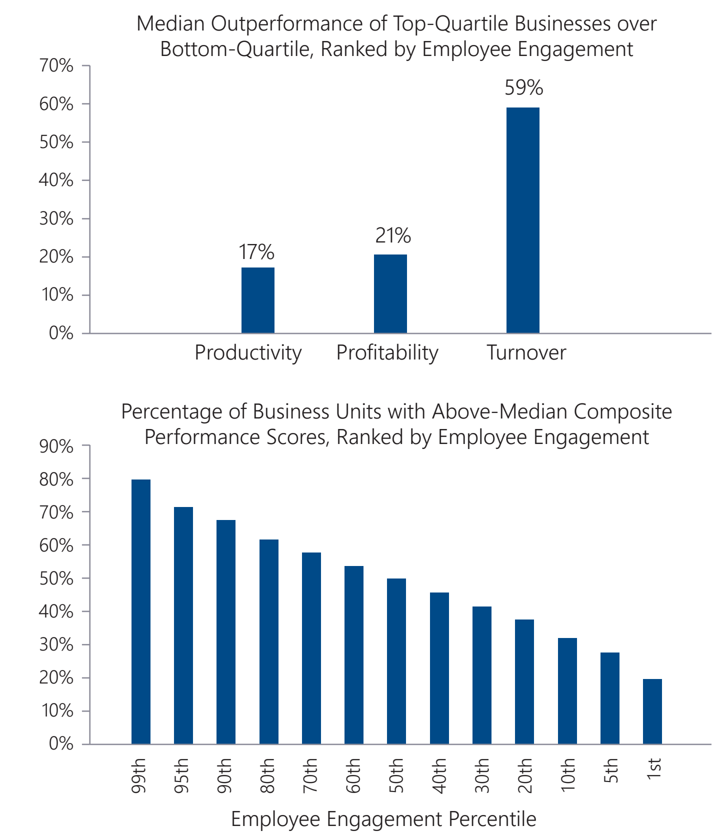


FIGURE 4

Businesses with High Employee Engagement See Markedly Better Results across Several Performance Metrics[17]



15 Carlyle Analysis of Portfolio Company Data, February 2020. Some companies lack data for 2015 or 2018, but all companies have at a minimum 3 years' worth of data.

16 Fedyk, Hodson; Trading on Talent: Human Capital and Firm Performance (November 18, 2017). Harvard Business School

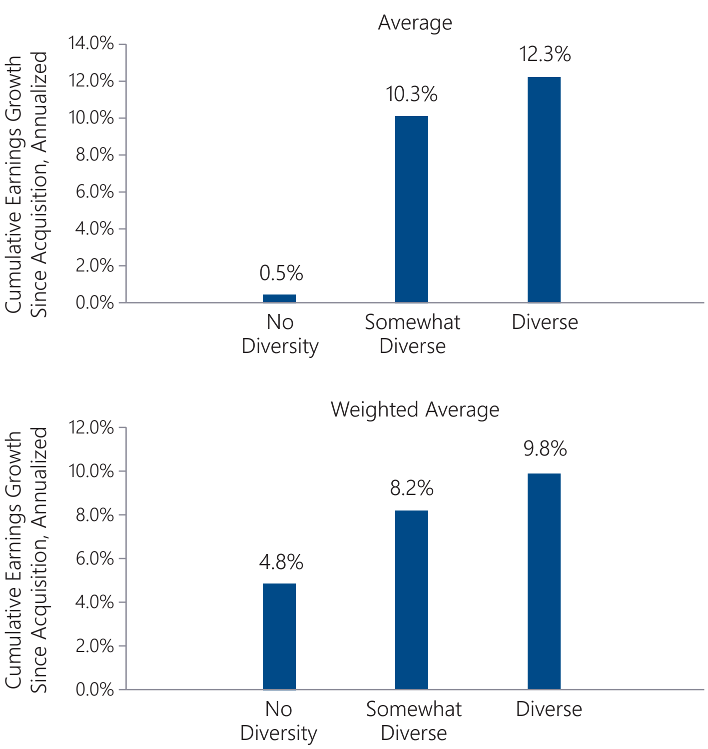
17 Gallup; The Relationship Between Engagement at Work and Organizational Outcomes; 2016.

Diversity Improves Decision-Making

In addition to issues of employment and job satisfaction, a total improvement approach prioritizes additional elements of human capital. For example, many impact-oriented investors prioritize diversity and inclusion and look to channel capital to businesses with diverse boards, founders, and leadership teams.[18] The data from our own companies support the growing consensus that diversity should be a priority of *all* funds with governance rights and influence, not just because it is a socially-desirable outcome, but also because diversity improves decision-making and financial outcomes.

FIGURE 5

Annualized Cumulative Earnings Growth Averages by Board Diversity Rank[19]



By promoting divergent viewpoints, board diversity contributes to more deliberative decision-making processes and more effective governance.[20] Over the past three full years, the average earnings growth of Carlyle portfolio companies with two or more diverse board members has been nearly 12% per year greater than the average of companies that lack diversity (Figure 5). After controlling for industry, fund, and vintage year, companies with diverse boards generate earnings growth that's five times faster, on average, with each diverse board member associated with a 5% increase in annualized earnings growth.

18 C.f. Consumer Technology Association Diversity Investment, 2019.
19 Carlyle Analysis of U.S. Portfolio Company Data, February 2020. "Diversity" refers to female, Black, Hispanic or Asian.
20 Carter, D, Simkims, B, Simpson W. "Corporate Governance, Board Diversity and Firm Value", The Financial Review 2003

Returns on Investment in Sustainability

Of all the issues for which investors seek opportunities to make an impact, perhaps none is as consequential as climate change. Whether through pure-play impact, infrastructure, or dedicated clean energy funds, billions of dollars have been raised for investments in renewable and sustainable source of energy, energy storage, and carbon capture technology and much more is needed. When including expected industry and public outlays, total investments in this space are expected to exceed $300 billion per year through 2040, with more than $550 billion required annually to reach the net zero emission goal of the Paris Agreement.[21]

While dedicated renewable energy funds will remain the primary channel to address opportunities from climate change, shifts in public consciousness have increased the returns on broader investments in sustainability. The past two years have witnessed a sharp rise in the use of the phrase "climate crisis" – in lieu of "climate change," "climate risk," or "global warming" – to describe the nature of the threat facing the planet (Figures 6 and 7). Such usage conveys a sense of urgency that has also been increasingly reflected in asset prices.

FIGURE 6

News Mentions of "Climate Crisis" by Month[22]

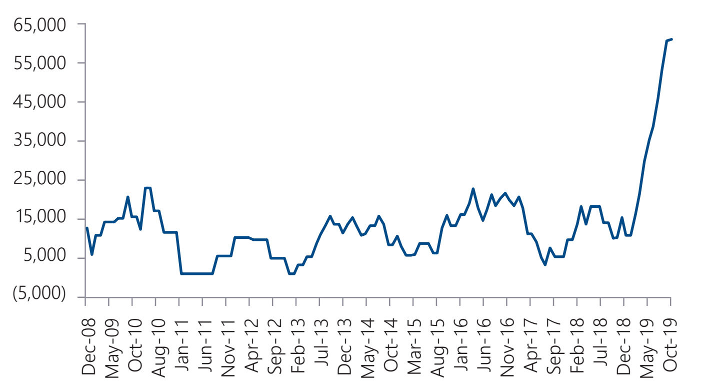
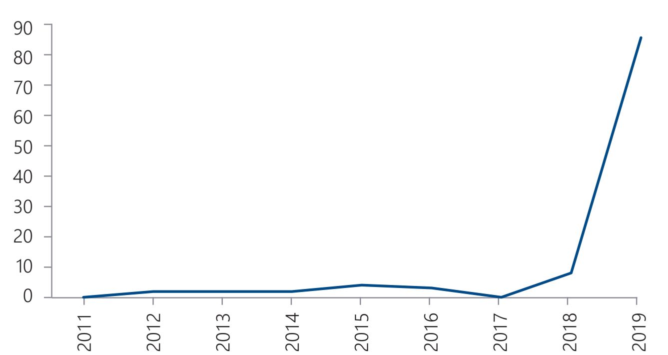


FIGURE 7

Investment Research Reports Including "Climate Crisis" by Year[23]



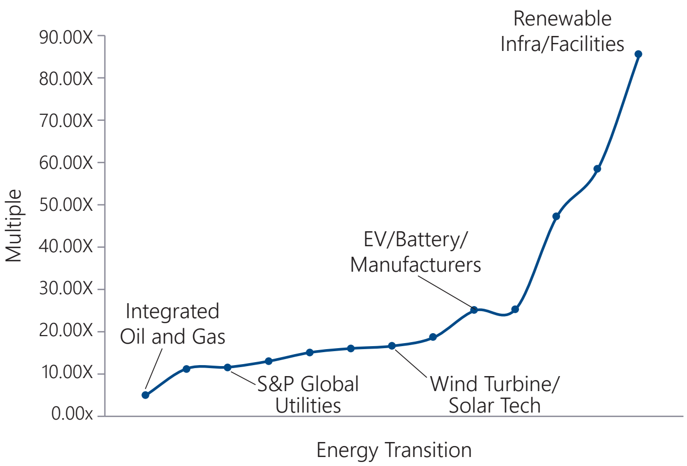
21 International Energy Agency, 2019 World Energy Outlook.
22 Carlyle Analysis; Google Trends.
23 Carlyle Analysis; S&P Capital IQ Database.

In today's market, consistent outperformance requires a total improvement mindset that is able to both perceive and capitalize on the financial returns generated in pursuit of societal goals.

As public fears of the nearer-term consequences of climate change have intensified, enormous disparities in energy sector multiples have emerged. Today, the valuation assigned to a given energy company largely depends on where its assets sit on the clean energy spectrum (Figure 8), creating compelling financial incentives to accelerate the energy transition in advance of changes in underlying energy consumption.

FIGURE 8

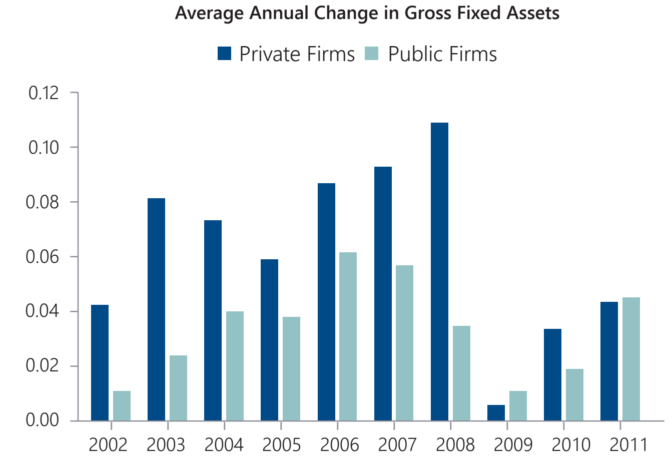
Valuation Multiples Have Adjusted to Energy Transition Risk in Advance of Changes in Fundamentals[24]



Thanks to longer holding periods and investment horizons, companies backed by private capital tend to invest more than their public counterparts and that investment tends to be more sensitized to changes in relative valuations (Figure 9). These climate-related shifts in asset prices incent private investors to reduce carbon footprints and deploy capital into green energy and related storage technology. Increasing renewables' (photovoltaic solar and wind) share of total revenue from zero to 40% could lead to a doubling of the typical energy company's trailing Ebitda multiple (Figure 10). Ironically, investments in oil and gas companies offer the strongest financial incentives to accelerate the global transition to clean energy – a fact not lost on private market investors with a total improvement orientation.

FIGURE 9

Private Firms More Sensitive to Investment Opportunities than their Public Counterparts[25]



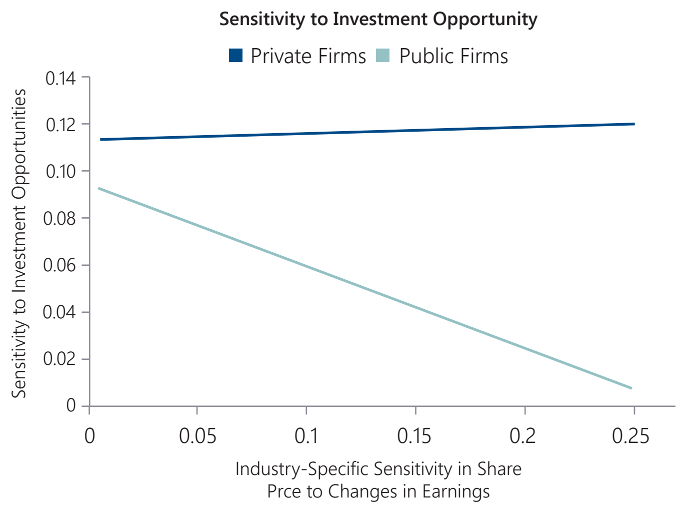
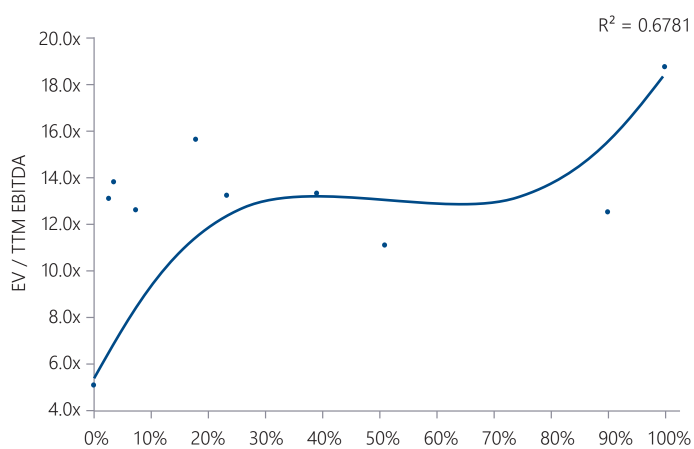


FIGURE 10

Adding Renewables Capacity to O&G Assets Can Produce Significant Multiple Expansion[26]



24 Carlyle Analysis; S&P Capital IQ Database.

25 Asker, John William and Farre-Mensa, Joan and Ljungqvist, Alexander, Corporate Investment and Stock Market Listing: A Puzzle? (October 4, 2014). Review of Financial Studies 28, no. 2 (February 2015): 342-390.

26 Carlyle Analysis of S&P Capital IQ Data, February 2020.

Investing for Impact

Pure impact funds channel capital in pursuit of important social and environmental goals; their potential to catalyze change in these areas and seed new growth opportunities make them an important part of the investment ecosystem. But the bifurcation of the market into "impact" and "traditional" funds can create a false dichotomy in the minds of observers that assumes high returns impose social costs, or that beneficial outcomes necessarily require some financial concession.

The same societal values that motivate investors to allocate towards impact funds have become increasingly reflected in broader asset prices. Above-market returns often come directly because of – not in spite of – actions that advance the social goals of the impact investor – as demonstrated by the examples here highlighting the financial impacts of greater inclusion and diversity, environmental sustainability, and responsible governance. In today's market, consistent outperformance requires a total improvement mindset that is able to both perceive and capitalize on the financial returns generated in pursuit of societal goals.

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Mr. Thomas has earned the chartered financial analyst designation and is a Financial Risk Manager certified by the Global Association of Risk Professionals.

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Ms. Starr received an MBA and a certificate in public management and social innovation from Stanford University's Graduate School of Business, where she was an Arbuckle Leadership Fellow, and an AB in environmental science and public policy from Harvard College, where she graduated magna cum laude.

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