Wharton
UNIVERSITY *of* PENNSYLVANIA
SOCIAL IMPACT INITIATIVE

# Great Expectations

## Mission Preservation *and* Financial Performance in Impact Investing

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# Executive Summary

*Given the pressure to find liquidity, GPs may face tradeoffs between maximizing financial returns and ensuring the preservation of portfolio companies' missions, and therefore, many wonder if GPs will sacrifice mission in exchange for financial returns.*

Impact investing provides investors opportunities to generate social and environmental value through their investable assets. Over the past decade, limited partners have increased capital allocations to socially driven private equity funds. In turn, these funds have increased investment in mission-driven portfolio companies with the goal of increasing the size of their revenues and assets, and the scope of their impact. As funds mature, the general partners (GPs) who manage them must find liquidity in their portfolio(s) in order to provide returns to their limited partner (LPs) investors[1]. For impact fund managers, the pressure to find liquidity may be particularly pronounced since the impact industry remains nascent and relatively unproven. In fact, the field is so new that critics and supporters see every exit as a proof point. Given the pressure to find liquidity, GPs may face tradeoffs between maximizing financial returns and ensuring the preservation of portfolio companies' missions, and therefore, many wonder if fund managers will sacrifice mission in exchange for financial returns.

To evaluate the interplay of liquidity and mission preservation in impact investing, the Wharton Social Impact Initiative (WSII), under the supervision of Dr. David Musto and Dr. Christopher Geczy, conducted a rigorous survey of 53 impact investing private equity funds from around the world. In the study, WSII evaluated a set of enabling factors and constraints that contribute to mission preservation, specifically 1) the extent to which LPs granted GPs legal permissions to pursue impact in investment and exit decisions; 2) the degree to which GPs obtain control or influence over exit outcomes; 3) financial performance of realized investments in the sample to evaluate the context in which GPs pursue social or environmental impact; and 4) overall financial performance of the industry to assess whether poor performance is placing further pressure on GPs to find financially optimal exits.

In traditional investment arrangements between fund managers and investors, GPs are held to professional standards and legal requirements to make investment decisions that deliver maximum risk-adjusted financial returns for LPs. However, in impact investing, virtually all GPs surveyed in the sample reported that LPs permitted them to pursue impact as part of the investment decision-making process, and in most cases required them to do so. The mandates are reflected in legally binding agreements like Limited Partner Agreements or Private Placement Memoranda.

> **"According to survey responses, GPs usually do not obtain a controlling interest of their portfolio companies' boards of directors, and therefore have little control over exit decisions."**

However, some question whether LP permissions or mandates are sufficient to protect company missions. According to survey responses, GPs usually do not obtain a controlling interest of their portfolio companies' boards of directors, and therefore have little control over exit decisions.

1 General partners are the fund managers who provide capital for portfolio companies, whereas limited partners are the investors or institutions that provide capital for the GP to invest.

Despite the seeming lack of control, GPs remain optimistic about mission preservation. For nearly all exits that were not write-offs, GPs reported that the mission continued post exit. A prevailing explanation from funds is that the social or environmental impact is inherent to the business model of portfolio companies and therefore does not rely on mandates from an acquirer.

Given the surveyed GPs' near-universal optimism towards mission preservation, WSII examined whether a clear financial tradeoff materialized in their investments. A common critique of impact investing broadly is that investors must expect concessionary financial returns in exchange for pursuing a social or environmental impact. While there does in fact remain a spectrum of return expectations in the industry, many funds seek to obtain market-rate returns. WSII assessed the financial performance of the subset of funds seeking market-rate returns, assuming that the tension between financial performance and mission preservation would be most acute in this group. Thus, the question becomes, do the impact funds specifically seeking market-rate returns receive concessionary returns?

Several calculations of financial performance suggest that market-rate-seeking funds could in fact achieve their targeted returns while also preserving portfolio companies' missions. In other words, the data show that impact funds did not have to make concessions in order to preserve the portfolio companies' missions upon exit.

The first calculation used by WSII was the public market equivalent (PME)[2], a calculation that provides a time weighted measurement that assesses performance relative to a market index. Specifically, it shows a ratio of performance between an investment and a selected market index (for example, a PME calculation of 1.00 indicates identical performance between an investment and a selected benchmark index over a set time horizon, and a PME greater than one indicates that an investment outperformed the market index). A pooled end-to-end aggregate PME calculation for the 170 market-rate-seeking investments in the sample returns a PME gross of fees, expenses, and carried interest of 0.98 (12.94%[3] IRR, 9.03%[4] mIRR)[5], compared to a spliced Russell Microcap/Russell 2000 index, indicating nearly identical performance with the market index. Further segmentation of the data demonstrates that mission-aligned exits (as reported by GPs) returned a PME of 3.09 (33.52% IRR, 10.34% mIRR), whereas the larger universe of exits returned a PME of 2.46 (35.01% IRR, 10.85% mIRR). This early data suggest aligned exits can demonstrate financial success. Among the sample, concessionary financial returns were not required to preserve the social or environmental effect of impact investments.

2 See Sorensen, M. and Jagannathan, R. (2014) for a detailed explanation of the PME methodology.

3 This return is using "Method 2" in the Methodology section.

4 Using a finance rate and reinvestment rate of 12%. See Gottschalg, O. and Phalippou, L. (2007). The Truth About Private Equity Performance. Harvard Business Review, December 2007.

5 All figures presented in this analysis are gross of fees, expenses, and carried interest.

**End-to-End Gross Performance of Realized and Unrealized Market-Rate-Seeking Funds' Aggregate Portfolio Companies[6]**

| | *Gross IRR* | *Gross mIRR* | *Microcap PME* | *S&P 500 PME* | *Time* | *# Portfolio Companies* |
|---|---|---|---|---|---|---|
| All | 12.94% | 9.03% | 0.98 | 1.00 | 1/1/2000-12/31/2014 | 170 |
| Exits Only | 18.59% | 9.46% | 1.46 | 1.55 | 1/1/2000-9/30/2014 | 51 |

**Realized Market-Rate-Seeking Funds' Mission Aligned Exits Versus All Market-Rate-Seeking Exits**

| | *Gross IRR* | *Gross mIRR* | *Microcap PME* | *S&P 500 PME* | *Time* | *# Portfolio Companies* |
|---|---|---|---|---|---|---|
| All Exits (Excluding Write-offs) | 35.01% | 10.85% | 2.46 | 2.56 | 9/30/2001-9/30/2014 | 32 |
| Mission-aligned Exits | 33.52% | 10.34% | 3.09 | 3.26 | 9/30/2001-9/30/2014 | 16 |

Other studies have examined median returns for a group of funds, but without further clarification of selection bias or a calculation of a confidence interval it is difficult to assess the representativeness of the findings for the industry at large.

In addition to the pooled aggregate calculations above, WSII examined individual fund performance and conducted statistical analysis in order to better understand the industry at large. By comparing individual performance of market-rate-seeking funds, WSII found a median PME of 0.95[7] compared with the spliced Russell Microcap/ Russell 2000 index, and calculated a confidence interval between 0.74 and 1.15. The confidence interval means the researchers are 95% certain that the true median performance of the whole industry lies between 0.74 and 1.15. Although the median fund in the sample did perform slightly below the index (since median PME < 1), the data suggest that the researchers cannot reject above a 95% confidence level that in general, impact-investing funds perform the same as the index.[8]

6 The data require an additional independent review to meet academic standards. WSII's analysis is heavily dependent on the accuracy and availability of source documents from GPs.

7 This calculation is performed using "Method 2" in the Methodology section.

8 The measure relies on individual performance of 16 funds, with data replicated 1000x via a bootstrapping exercise.

Market-rate-seeking impact investments in the sample, therefore, may be financially competitive on a gross basis with other equity investing investment opportunities. This financial performance may be why impact fund managers often assert that there is little inherent tension between profits and "purpose."

This lack of tension may be driven by funds' use of an "embedded impact" strategy. In other words, impact fund managers use a pre-investment screening process to invest only in companies with products or services that are inherently impactful, making impact core to the investee's business model. For impact investors at large, the research findings highlight the importance of the due diligence stage of the investment process.

However, beyond concerns related to mission preservation, broader questions remain about the responsibility of GPs to encourage long-term impact. For example, some investors continue to question whether it is even a GP's purview to influence or control post-exit performance after the GP is out of the deal. Alternative and innovative forms of financing may be more consistent with the goals of impact investors, for example, and some posit that a more effective way of growing value would be to hold portfolio companies until they become large or successful enough to dictate the mission-related terms of their exits or to become acquirers themselves.[9]

The following report includes deeper discussion about the context, methodology, sample set characteristics, findings, and implications of the research.

9 To address these issues, investors will need more quantitative and data-driven information that fall beyond the scope of this report, such as additional metrics on social impact pre and post exit, and further clarity on the long-term impact for which they are accountable.

## About the Wharton Social Impact Initiative (WSII)

*The Wharton Social Impact Initiative (WSII) leads the Wharton School's work in impact finance, social entrepreneurship, impact analytics, and strategic corporate social impact. WSII collaborates with leaders across sectors to apply business strategies to create a better world. WSII's work includes research, consulting, hands-on training, and outreach, and spans many geographic and topical focus areas, including Philadelphia, Africa, women and girls, and others. By leveraging Wharton's hallmark strengths, WSII advances the science and practice of business social impact and develops business leaders who are equipped to lead in an increasingly interconnected and complex world. To learn more about our work, please visit socialimpact.wharton.upenn.edu.*

## Acknowledgments

- The Wharton Social Impact Initiative (WSII) offers a special acknowledgment to Skopos Impact Fund, who catalyzed this research, exemplifying that the private sector can work with academic institutions to create works for the public good.

Skopos Impact Fund ("Skopos") is a global, private, impact-investing fund that aims to promote human dignity and social justice through impact investing. The capital that Skopos invests is from endowed, philanthropic resources of the Brenninkmeijer family of entrepreneurs. The entity was incorporated and issued its first commitments in the fall of 2014. Skopos looks to invest an initial €100 million in the next two years. Skopos is professionally managed by a dedicated team of impact investing specialists within Anthos Asset Management in Amsterdam, led by Lisa Hall. Skopos also works with external specialists in local markets and with industry specific expertise.

- WSII offers a special thank you to the Emerging Markets Private Equity Association (EMPEA), and especially Pat Dinneen, for their support and guidance developing the research.

EMPEA is the global industry association for private capital in emerging markets. They are an independent non-profit organization with over 300 member firms, comprising institutional investors, fund managers, and industry advisors, who together manage more than US$1 trillion of assets and have offices in more than 100 countries across the globe. They support members through global authoritative intelligence, conferences, networking, education, and advocacy.

- WSII offers a special thank you and acknowledges the support and many contributions of the following organizations:

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- WSII also offers a thank you to all the funds that have participated in helping to build the Impact Investing Database. We encourage other impact fund managers to share their experiences with us. Please contact Jacob Gray at ImpactInvesting@wharton.upenn.edu for further details on how to contribute to this ongoing study.

Report

*Great Expectations:*

*Mission Preservation and Financial Performance in Impact Investing*

# Introduction

*Over the past decade, there has been a dramatic increase in the number of investors seeking to achieve financial returns as well as measurable social or environmental impact from their investments.*[10]

In particular, impact investing in the private equity realm gained serious attention due to its dramatic growth and potential to bring transformative change to social and environmental problems. Some impact-investing private equity firms have been capitalizing on these so-called double and triple bottom line returns[11] for years.[12] Despite anecdotal success, however, the industry does not benefit from an academically rigorous analysis of social, environmental, and financial performance. While the industry continues to attract new investors and additional capital[13], institutional investors remain reluctant to dedicate larger sums of capital for impact in the absence of clear evidence regarding impact funds' financial performance. Further, impact investing in private equity is only sustainable and scalable to the extent that it produces financial returns comparable to the targeted returns set by general partners (GPs)[14] themselves. For many GPs, this means achieving market-rate returns.[15]

The combination of a growing number of deals alongside an abiding focus on market-rate returns raises an important set of questions. Closed-end funds eventually provide their limited partners (LPs) with liquidity by exiting investments. As existing portfolios mature and fund managers look for exit opportunities, practitioners have identified several fundamental considerations:

- Will the impact fund's exit affect the company's social or environmental mission?
- Are incentives aligned between funds, portfolio companies, and acquirers to ensure the preservation of company missions?
- What happens if there is tension between mission preservation and the economics of the exit?

10 The 2015 Impact Investor Survey by J.P. Morgan and the Global Impact Investing Network (GIIN) finds, "a 7% growth in capital committed between 2013 and 2014 and a 13% growth in number of deals" among 82 organizations. Respondents report an expected increase in capital raised from US$4.7 billion in 2014 to US$7.1 billion in 2015. See "Eyes on the Horizon: The Impact Investor Survey". J.P. Morgan, Global Impact Investing Network. Retrieved from http://www.thegiin.org/binary-data/RESOURCE/download_file/000/000/662-2.pdf

11 Triple bottom line refers to financial, social, and environmental outcomes.

12 The World Economic Forum estimates there are more than 300 such funds around the world. See Drexler, M., & Noble, A. (2014). Impact investing: A primer for family offices. Retrieved from http://www.weforum.org/reports/impact-investing-primer-family-offices

13 In the 2015 Impact Investor survey, funds reported an average target of 44 investees representing $85mm in total invested capital for 2015, a projected increase of 21% in the number of companies receiving funding and 18% more capital delivered than in 2014.

14 General partners are the fund managers who provide capital for portfolio companies, whereas limited partners are the investors or institutions that provide capital for the GP to invest.

15 In the 2015 JP Morgan/GIIN Impact Investor Survey, 55% of respondents report seeking "competitive, market-rate returns."

Industry research provides insight into some of these questions. The 2015 Impact Investor Survey by J.P. Morgan and the Global Impact Investing Network (GIIN) indicates that firms do consider mission preservation at exit. According to the report, 61% of impact investors try to mitigate this risk, and those that do use three general methods: they (1) select investees who embed impact into their core mission (51%); (2) select an acquirer that they believe will protect the mission (30%); or (3) set specific objectives to hold an acquirer accountable to the mission (13%). Of investors who do try to mitigate this risk, most point to the embedded impact of the company as the primary method of preserving mission.

The Wharton Social Impact Initiative (WSII) built from other industry and academic research to assess financial return results within the context of their social or environmental impact. The interplay between liquidity and mission drift is a pressing concern for investors concerned with preserving impact, as well as those seeking market-rate returns. The impact investing industry is nascent and

> **"WSII deployed methodologies not yet applied to the impact industry, like public market equivalents, modified internal rates of return, and confidence intervals around performance, to better understand the implications for the industry."**

relatively unproven, so analysis relies on small sample sizes. WSII deployed methodologies not yet applied to the impact industry, like public market equivalents, modified internal rates of return, and confidence intervals around performance, to better understand the implications for the industry despite the small sample size.

WSII focused on the link between liquidity and mission preservation, and collected and analyzed data from impact-investing private equity funds to explore four key components of this link:

1. ***Permission*** – Do fund managers have sufficient legal latitude from their LPs to make mission-aligned investment choices?
2. ***Control*** – Assuming fund managers have appropriate permissions, do they have sufficient control of company boards of directors to determine the exit outcomes?
3. ***Motivation*** – What is the financial performance of mission-aligned exits to date?
4. ***Overall Industry Performance*** – What might be expected of financial and social performance moving forward?

# About the Research: Scope, Focus, and Methodology

In 2014, WSII began targeting private equity funds from around the globe that self-identified as impact investors[16] or investors whose portfolios contained impactful companies (e.g., foundations).[17] With this in mind, WSII specifically sought GPs that self-reported positive return expectations and the intention to create measurable social or environmental impact through private equity and mezzanine financing investments.[18] In conjunction with Wharton finance faculty, WSII developed a data collection survey instrument, with 89 unique variables spanning both fund- and transaction-level data. Under strict confidentiality protocol, WSII also requested source documents such as annual audited financial statements, quarterly reports, private placement memoranda (PPM), limited partner agreements (LPA), modifying side letters, and late-stage term sheets. With express permission from participating funds, WSII also gathered data directly from B Lab for funds that have undergone the Global Impact Investing Rating System (GIIRS) rating process.[19]

## Definitions

Two definitions in this report call for particular clarification. WSII asked respondents a pair of questions about mission preservation for every exit by the fund. For every liquidity event reported, WSII asked if there were 1) statements in the realization agreement to pursue the social or environmental impact of the underlying portfolio company and 2) whether the fund believed the mission of the company persisted post exit. Based on these responses, WSII observed exits within two categories of alignment:

***A. Aligned Exits*** – those that the fund manager believed the mission persisted post exit, and

***B. Deeply Aligned Exits*** – those that included a statement to pursue the mission in the realization agreement.

Answers to these questions serve as proxies for estimating mission preservation of exited portfolio companies.[20]

16 WSII based the definition of "impact investor" on the criteria developed by the Global Impact Investing Network (GIIN). The GIIN defines impact investing as "investments made into companies, organizations, and funds with the intention to generate social and environmental impact alongside a financial return." See, GIIN: About impact investing at http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html

17 WSII crafted its initial outreach list by working with organizations like B Lab, Emerging Markets Private Equity Association (EMPEA), Anthos Asset Management and scanning available lists like ImpactBase and the Impact Assets 50. Through these resources, WSII compiled a contact database of 437 funds. To date, WSII has distributed more than 200 invitations to fund managers for participation in the study. As of August 14, 2015, 53 total impact funds, representing 557 portfolio investments, had submitted responses to the WSII database.

18 WSII recognizes that investments in several asset classes can be considered impact investments. However, the scope of this report is limited to private equity investments.

19 The Global Impact Investing Rating System (GIIRS) provides an assessment of impact measurement at the fund and portfolio company level. See b-analytics.net/giirs-ratings for additional information.

20 For this report, WSII did not attempt to measure the social or environmental impact of portfolio companies but rather explored evidence of intent and perception of mission preservation. The researchers determined analysis of impact metrics to be outside the scope of this report, as there is only sparse standardized or easily verifiable data in this regard. WSII recognizes the importance of measuring impact and hopes to pursue more research on this topic in the future.

| | | *Do you believe that the social or environmental impact persisted after the company exited the fund?* | |
|---|---|---|---|
| ***Does the realization agreement include a statement to pursue the social / environmental impact objective of the underlying company?*** | | ***Yes*** | ***No*** |
| | ***Yes*** | Deeply Aligned | X** |
| | ***No*** | Aligned | Not Aligned |

*(**WSII had no observations in this category, presumably because all instances of reported statements to pursue impact led to a corresponding belief in the preservation of the company's mission.)*

## Valuations

WSII calculated internal rates of return, cash multiples, modified internal rates of return, and public market equivalents by aggregating transaction-level cash flows end-to-end by quarter from all GPs that had provided data by August 14, 2015. In addition to the aggregate calculations, WSII examined individual performance of funds compared to market indices to calculate individual funds' PMEs. *Table 1* summarizes the strengths and limitations of each of these calculations.

*Table 1*

| *Method* | *Strengths* | *Limitations* |
|---|---|---|
| ***Internal Rate of Return (IRR)*** | Easy point of comparison with other research reports and fund documents | Assumes a reinvestment rate at IRR, which can exaggerate the magnitude of extreme performers |
| | Accounts for timing of cash flows | Possible distortion of aggregate cash flows due to switching signs (cash in/cash out) |
| | | "Absolute performance measure that does not adjust for market return or risk of investments"[21] |
| ***Cash Multiple*** | Requires no assumptions to calculate | Time value is not factored |
| ***Public Market Equivalent (PME)*** | Benchmark measurement against other equity investment opportunities | Not a widely reported metric of performance for industry participants |
| | Mitigates macro level impacts on performance | |
| ***Modified Internal Rate of Return (mIRR)*** | A more accurate measure of performance than the IRR[22] | Calculation can be distorted by the small cash flow amounts at the start of the aggregate cash flow |
| | | Possible distortion of aggregate cash flows due to switching signs (cash in/cash out)[23] |

21 See Sorenson, M. and Jagganathan, R. (2013). The Public Market Equivalent and Private Equity Performance. Or see Kaplan, S. and Schoar, A. (2005). Private Equity Performance: Returns, Persistence, and Capital Flows. The Journal of Finance, Vol LX, No 4, August 2005.

22 See Gottschalg, O. and Phalippou, L. (2007). The Truth About Private Equity Performance. Harvard Business Review, December 2007.

23 The mIRR calculation is sensitive to the direction, sequence, and weight of cash flows.

For the public market equivalent, WSII used two benchmark indices with which to compare performance of investments in the dataset. The first benchmark is a spliced Russell index. This benchmark tracks the Russell 2000 Growth index from 2000 to 2005 and the Russell Microcap index from 2006 to 2015. The benchmark is spliced in an effort to most closely mirror the types of investments between private equity and small, publicly traded companies. The second benchmark is the S&P 500 Total Return index. Although the S&P 500 is not highly comparable in terms of private equity investments, it is a common reference for performance that has been used in other previous academic research.[24]

Since this is a global study, WSII encountered a high variability of valuation standards among funds. Determining a proper valuation for unrealized investments held on balance sheets is a challenge. Some funds assign a Fair Market Value (FMV) to unrealized investments whereas other funds elect to use valuation standards that hold unrealized investments strictly at cost. WSII used several methodologies to account for these differences and to permit analysis. The overall performance of all investments (realized and unrealized) is largely dependent on how conservatively or aggressively valued are the unrealized investments.[25] With this understanding, WSII presents performance calculations based on several different valuation methods in order to show the spread of possible performance using various assumptions.

*Table 2*

| ***Method 1*** | ***Method 2*** | ***Method 3*** |
|---|---|---|
| ***Held at FMV or Cost*** | ***Held at FMV or (Cost x (Val FMV/Cost FMV))*** | ***Excluding those at cost*** |
| This method holds open investments at reported value, either at a GPs' FMV or at cost of the investment. It uses valuations as they are reported on financial documents. | This method adjusts the valuations of the companies held at cost by applying a ratio derived from the other open investments valued by GPs. By analyzing the initial cost of FMV investments compared to the reported holding value, WSII determined a ratio to apply to all companies held at cost. | This method disregards the open investments held at cost. It does not make any further assumptions about companies held at cost and does not attempt to adjust the values of any portfolio companies. |

24 See Kaplan, S. and Schoar, A. (2005). Private Equity Performance: Returns, Persistence, and Capital Flows. The Journal of Finance, Vol LX, No 4, August 2005.

25 Sample includes 81 portfolio companies from market-rate-seeking funds reported held at cost out of a total of 170 portfolio companies analyzed (48%).

There are additional important caveats for the data and analysis. First, the data are verified to WSII's best efforts but require an additional independent review to meet academic standards (i.e., for publication in an academic journal). This report reflects an initial analysis of the available information. WSII will engage in an independent review of the data and reserves the right to append and modify findings if necessary. Second, the data only represent information that was provided to WSII as of August 14, 2015. Third, WSII's reconstructed cash flows and values of cash in and cash out of the aggregate fund are dependent on the availability of source documents, and WSII assumes all source documents provided from GPs are accurate. In a handful of cases, source documents were not provided for the full life of the fund. In this event, cash flows were generated only from the available source documents, and WSII assumed a realization event at the time of the last data observed. Without additional information, the team did not speculate whether the fund continued to hold the investment. Finally, all cash flows were converted to US dollars using historical exchange rates at the time of cash in and cash out.[26] For modified rate of return calculations, the finance and reinvestment rates were held constant, with the most conservative measure using historical long-term composite >10 year Treasury bond rates and another measure using a generally accepted industry standard rate of 12%.[27]

26 Out of 170 transactions for market-rate-seeking funds, 32 portfolio company valuations were reported in foreign currencies and were converted into USD using historical rates at the time of cash in or cash out.

27 For historical treasury rate data used for this report, see http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=longtermrateAll

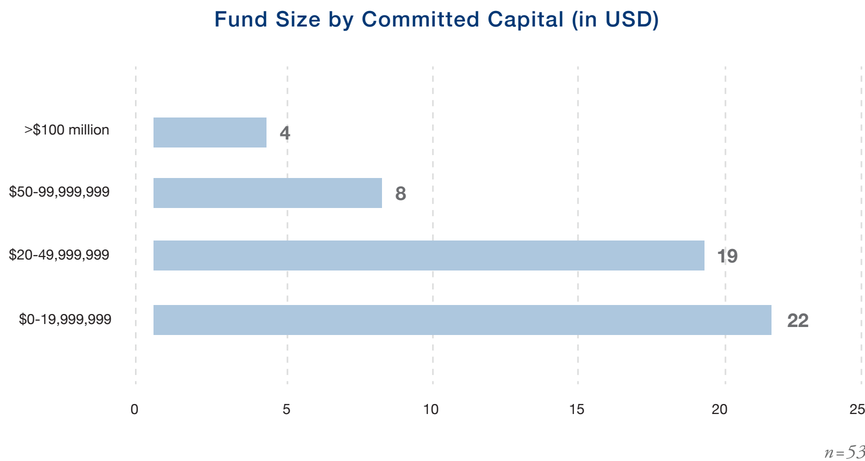
# Description of Sample

*WSII obtained information from 53 impact investing private equity funds, representing 557 individual investments. The sample size is modest, but sufficient to yield initial observations. The following section describes the current composition of the dataset.*

## Size of Funds

The median fund size in terms of the amount of committed capital in the sample is US$22.5 million. Over three quarters (77%) of the sample is composed of funds with fewer than US$50 million in committed capital. Only 8% of the funds in the sample have more than US$100 million in committed capital.

**Fund Size by Committed Capital (in USD)**

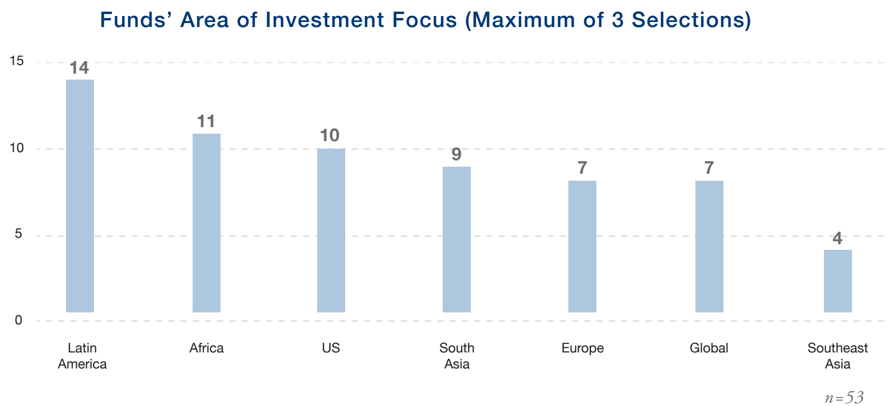



*n=53*

## Geographic Focus

The sample's geographic investment focus is wide ranging but with a weight towards Latin America (26%) and Africa (21%). Other areas of investment focus include Europe, the United States, East/Southeast Asia, and South Asia.[28] In the survey, funds could select up to three areas of focus before being considered a global fund.

**Funds' Area of Investment Focus (Maximum of 3 Selections)**




*n=53*

28 East/Southeast Asia includes investments in China, Japan, Cambodia, Vietnam, and Thailand. South Asia includes India and Bangladesh.

## Fund Size by Type

Funds self-identified as one of the following classifications: buyout, growth private equity, mezzanine, venture capital, angel investor, or hybrid.[29] Venture capital and growth private equity comprise nearly two-thirds of committed capital (65%) and number of funds (70%) in the sample, but hybrid, mezzanine, and buyout funds demonstrate the largest average committed capital per fund.

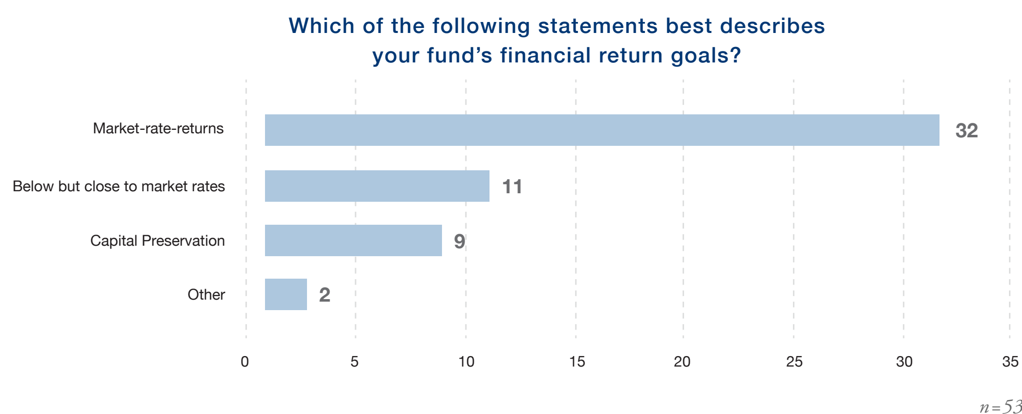
**Funds by Type and Size (in USD)**

| *Fund Type* | *Total Committed Capital* | *# Funds* | *Average Committed Capital* |
|---|---|---|---|
| Venture Capital | $775,805,723.00 | 21 | $36,943,129.67 |
| Growth PE | $607,544,500.00 | 16 | $37,971,531.25 |
| Hybrid | $466,390,628.00 | 8 | $58,298,828.50 |
| Mezzanine/Buyout | $280,700,000.00 | 6 | $46,783,333.33 |
| Angel Investor | $2,250,000.00 | 2 | $1,125,000.00 |

## Financial Return Goals

Impact investing private equity spans a spectrum of return expectations.[30] While the industry does not have a consistent taxonomy or specific language to describe these variations, WSII used three commonly used categories to distinguish between funds seeking market-rate returns, below but close to market-rate returns, and returns closer to capital preservation. Sixty percent of funds in the sample reported seeking market-rate returns.[31]

**Which of the following statements best describes your fund's financial return goals?**




*n=53*

29 Hybrid funds include combinations of debt and equity at various investment levels.

30 See 2015 J.P. Morgan/GIIN Impact Investor survey for more detail.

31 Compared to the 2015 J.P. Morgan/GIIN survey, which found 55% of respondents seeking market-rate returns.

## Portfolio Company Characteristics

Beyond the fund-level descriptors above, WSII also examined some key attributes of underlying portfolio companies in the sample. Responding funds report a majority (52%) of their portfolio companies as profitable. In terms of employment, 61% of the sample consists of companies with fewer than 100 employees. Seven percent of the sample report more than 1,000 employees.[32]

## Sample Bias Considerations

The sample size creates inherent challenges, but WSII sought to understand how representative the sample may be of the overall industry. Using available sources of information from ImpactBase, the Global Impact Investing Network (GIIN), and Thomson One, the researchers compared characteristics of survey participants to those of funds from the overall industry to assess whether the current sample is subject to observable biases. WSII examined the number of portfolio

> **"When comparing number of portfolio companies and funds under management, the current sample appears similar to nonparticipants. When looking at committed capital, this report's dataset skews toward slightly smaller and potentially less mature funds."**

companies per fund, the number of funds per management company, and committed capital per fund. The number of funds under management and the number of portfolio companies are proxies for size and success, while committed capital is a proxy for size and maturity.

When comparing number of portfolio companies and funds under management, the current sample appears similar to nonparticipants. When looking at committed capital, this report's dataset skews toward slightly smaller and potentially less mature funds. For example, the ImpactBase Snapshot[33] indicates that the average fund's committed capital is USD$52.5 million, whereas WSII's average fund's committed capital is USD$40.2 million. Additionally, an element of survivorship bias exists among the sample, as WSII obtained data only on funds that are or were managed by firms that remain in business.

32 While the number of employees may serve as a proxy for the overall size of funds' underlying companies, respondents were not asked to differentiate between the status of those employees (e.g., full time or part time).

33 See http://www.thegiin.org/binary-data/ImpactBaseSnapshot.pdf for more information.

# Findings

*As the impact-investing industry scales and grows, issues pertaining to liquidity and mission preservation remain a concern for private equity investors. WSII was particularly interested in exploring financial performance in the context of whether the social or environmental impact of portfolio companies was preserved following a successful exit from one of the sample funds.*

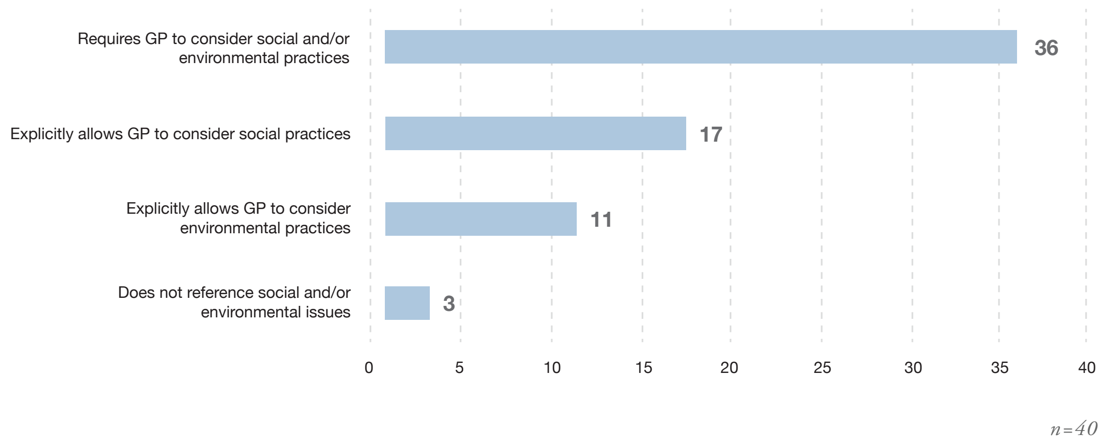
WSII examined four components of the link between liquidity and mission preservation: legal permission to pursue impact, the degree to which fund managers have control to influence exit decisions, motivation to pursue mission-aligned exits, and overall financial performance of the sample. The following provides more detail on each component.

## 1. Permission

*Do fund managers have contractual latitude, or "permission," to protect mission if it potentially conflicts with the economics of the deal?*

In traditional investment arrangements between fund managers and investors, GPs are held by professional standards and legal requirements to make investment decisions that deliver maximum risk-adjusted financial returns for LPs. In the context of impact investing, many LPs expect that investment decisions include a consideration of social or environmental impact. GPs must weigh their fiduciary duty to their LPs with the impact mission of the fund. WSII asked respondents to report the level of structural protection for fund managers to consider non-fiduciary factors in their investment decisions.

Unsurprisingly, survey respondents report the vast majority of Limited Partner Agreements, Private Placement Memoranda, or other comparable investment agreements either explicitly allow or, in most cases, require fund managers to consider mission in investment decisions. Specifically, 90% have investment or legal documents that explicitly allow fund managers to consider social and/or environmental issues and 70% go so far as to require them to do so.




*n=40*

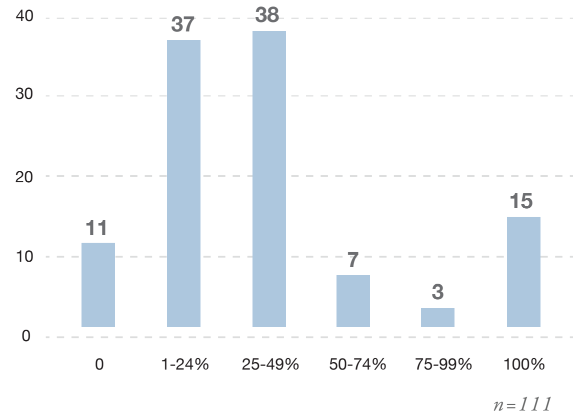
## 2. Control

*Do funds have sufficient control over exit decisions to ensure mission preservation?*

Most venture or private equity-backed companies are led by a board of directors which make major decisions, including those related to exiting investments. It is customary for investors to acquire a percentage of controlling votes on portfolio company boards of directors at the time of investment. To control exit outcomes, mission-aligned investors must control a majority of the seats, either alone or with allies, unless contractually enabled to influence decisions beyond the scope of their size and board composition (e.g. through minority shareholder rights). In practice, the composition of company boards often changes many time throughout the life cycle of an investment. For instance, impact investors may find themselves co-investing with traditional investors who demand their own representation. As impact companies grow and require larger sources of capital, the (usually smaller) impact investors may see their influence eroded.

Funds in the sample mostly reported that they do not control sufficient percentages of votes on boards of directors to determine exit decisions. For 77% of the portfolio companies in the dataset, mission-aligned investors – voting together as a block – had not secured 50% or more of the votes required to control exit decisions. Although impact funds' own charters may provide latitude to consider non-financial factors in exit decisions, funds may not be in a position to influence these decisions to an appreciable degree.

"What percentage of votes does your firm, and other investors aligned with your mission, control in relation to decisions about the investors' exit from the company?"




*n=111*

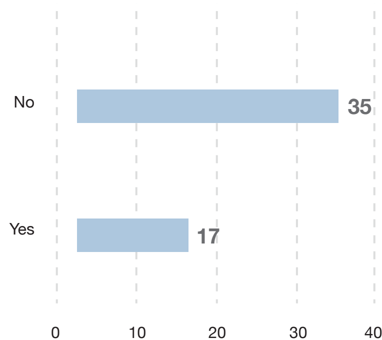
## 3. Motivation

*Do company missions persist after impact funds exit investments?*

WSII asked fund managers to report whether realized investments, either at a gain or loss, maintained company missions after the investment exited the fund. A separate question asked fund managers to report whether realization agreements with acquirers included language to preserve the portfolio company's mission.

*Does the realization agreement include a statement to pursue the social/environmental impact objective of the underlying company?*

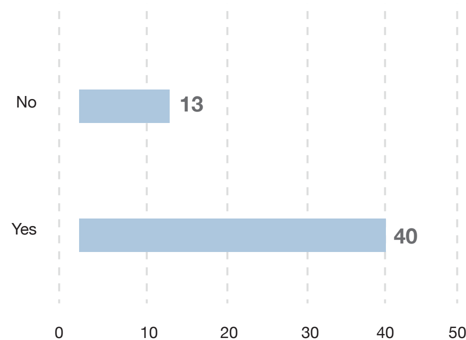
**Deeply Aligned Exit**




**Note: "No" response includes 11 write-offs*

*Do you believe that the social or environmental impact persisted after the company exited the fund?*

**Aligned Exit**




**Note: "No" response includes 11 write-offs*

Funds virtually always report that the mission persists in companies that are sold or acquired, even though a lower percentage report having statements in the realization agreements. It is important to note that GPs reported write-offs in this sample.[34] By definition, a company that is liquidated cannot continue its impact mission. Removing write-offs leaves only 2/42 (5%) instances when a GP expressed a belief that the mission did not persist.

The sidebar contains excerpts of responses from fund managers who believed the impact persisted. Many of these comments reflect that funds pursue companies that have social impact "embedded" as a core business element.

### *Do fund managers have financial motivation to pursue non-aligned exits?*

An assumption about the impact-investing industry is that mission-aligned exits necessarily entail concessionary financial returns. If true, fund managers would have financial motivation to pursue non-aligned exits in order to obtain higher returns for investors, placing the long-term preservation of portfolio company missions at risk.

WSII examined data from market-rate-seeking funds to find out whether the investors in this sample accepted a discounted price upon a successful mission-aligned exit, or whether fund managers achieved comparable market-rate returns while preserving mission. WSII examined the subset of funds seeking market-rate returns, assuming that the tension between liquidity and mission preservation would be most acute in this group.

#### Sample responses for, "Why do you believe that the impact persisted?"

"The company has a strong impact mission which is communicated to and understood by investors pre-investment."

"The company has a strong mission and investors are aligned with the mission."

"The company is still in the same location." (Mission is to create employment in urban distressed areas.)

"All our deals have their brand wrapped up in impact."

"Microfinance activities continued."

"The investment was structured as a self-liquidating investment, therefore the realization never affected the impact or purpose of business model."

"As company continues to grow, the impact and the value it creates for the local community will only grow."

"Fund remains on the board and is actively involved" (Not a full exit.)

"Commitment of one of the Board of Directors members."

34 Eleven write-offs are included in the numbers above.

The overall internal rate of return of realizations for the portfolio companies from market-rate-seeking funds is 18.59% – gross of fees, expenses, and carried interest.

WSII isolated mission-aligned exits and performed the same calculation. As noted above, aligned exits by definition exclude write-offs, as a company's mission cannot persist if it goes out of business. Therefore, the team expected the IRR for aligned exits to be high relative to the 18.59% IRR for all exits in the sample. The gross internal rate of return for mission-aligned exits is 33.52%.

In order to obtain a more comparable figure, WSII included the IRR of all portfolio company realizations in the sample, this time excluding write-offs. The gross internal rate of return for this group is 35.01%.

**Market-Rate-Seeking Exits, Gross Returns**

| | ***All Market-Rate-Seeking Exits*** | ***Market-Rate-Seeking Exits (Excluding Write-offs)*** | ***Aligned Exits**** | ***Non-Aligned Exits*** |
|---|---|---|---|---|
| ***Gross IRR*** | 18.59% | 35.01% | 33.52% | Insufficient Sample |
| ***Cash Multiple*** | 2.30x | 4.12x | 4.86x | " |
| ***n*** | 51 | 32 | 16 | 3 |

**Note:* *Aligned Exit category includes seven Deeply Aligned Exits*

The number of exits in the dataset is modest. Still, for the exits that fund managers reported confidence in mission preservation – aligned exits – the gross IRR (33.52%) is comparable to the larger set of all exits, excluding write-offs (35.01%).[35]

A key point to highlight here is not that aligned exits produce similar returns as non-aligned exits but rather that this early data suggest aligned exits can demonstrate significant financial success. Concessionary financial returns are not required for the social or environmental impact of impact investments to persist, at least as reported by fund managers in this sample.

***"The data show mission-aligned exits can demonstrate success – concessionary returns are not required for company missions to persist..."***

35 It is important to note that the small sample size and distribution of returns play a large role in this calculation. The two largest investments of the 16 mission-aligned exits were also two of the top three best performers of the group, with IRRs of 120% and 60% respectively. Their investment size and performance buoys the aggregate IRR; however, this distribution is not dissimilar to traditional private equity performance. Only three of the 16 mission-aligned exits returned negative IRRs.

## 4. Overall Industry Performance

*Would overall industry performance suggest that there is pressure to make non-aligned exits?*

WSII assessed the financial performance of all portfolio companies in the sample in order to glimpse what might be expected for fund managers considering exits in the near future. If performance is not strong, fund managers may be tempted to seek maximum returns at the expense of mission preservation. On the other hand, if the industry is performing well, presumably there will be less tension between economics and mission preservation.

WSII pooled end-to-end quarterly cash flows for all portfolio companies with verifiable financial data. This entire sample represents 240 companies since the first quarter of 2000. However, the following analysis is focused on market-rate-seeking funds, representing 170 portfolio companies.

Evaluating unrealized investments introduces an array of methodological challenges. For this sample, WSII conducted a best assessment of value of open investments based on multiple assumptions about company valuations. The following figures are largely dependent on how conservatively valued are the unrealized investments. WSII applied three distinct methodologies to assess a spectrum of overall performance of the sample.[36]

*Aggregate gross IRR and cash multiple for all portfolio companies (realized and unrealized) from funds seeking market-rate returns.*

**Market-Rate-Seeking Funds: Aggregate Analysis****

| | *Held at FMV or Cost* | *Held at FMV or (Cost x (Val FMV/Cost FMV))** | *Excluding Those at Cost* |
|---|---|---|---|
| *Microcap PME* | 0.89 | 0.98 | 1.09 |
| *S&P 500 PME* | 0.91 | 1.00 | 1.12 |
| *Gross IRR* | 9.20% | 12.94% | 14.65% |
| *Gross mIRR: 12%* | 8.95% | 9.03% | 9.24% |
| *Gross mIRR: T-Rates* | 3.72% | 3.95% | 4.00% |
| *Cash Multiple* | 1.39x | 1.61x | 1.77x |
| *n* | 170 | 170 | 89 |

** Sample includes 81 portfolio companies reported at cost, whose terminal values were calculated using ratio obtained from other companies in the sample set.*

*** Terminal Values for unrealized companies were treated as cash out at the time of the last observed value.*

36 See Methods 1-4 outlined in the Methodology section for more information.

Depending on the valuation methodology applied to open investments, impact investments in the sample demonstrated gross performance near market indices as seen by the PME calculations (between 0.89 and 1.09 for the Russell Microcap PME, and between 0.91 and 1.12 for the S&P 500 PME).

In addition to the end-to-end calculations for all market-rate-seeking funds' cash flows (as if part of one aggregate fund), WSII also analyzed performance on an individual fund basis. WSII compared gross performance of market-rate-seeking funds (when unrealized investments held at cost are adjusted according to reflect broader FMV valuations[37]) to a Russell Microcap index and found a median PME of 0.95.

Due to the sample size[38], it is difficult to assess how representative these findings are for the general population of impact funds. However, WSII used a bootstrapping simulation (1,000x, with replacement)[39] to calculate a confidence interval. Since a PME reflects performance relative to an index, a calculation of 1.00 indicates identical performance. WSII began statistical analysis with the null hypothesis that social impact investments perform the same as market indices. The following chart reflects the confidence interval for each calculation.

**Market-Rate-Seeking Funds: Individual Analysis**

| | *Confidence Interval (Lower Bound)* | *Median* | *Confidence Interval (Upper Bound)* |
|---|---|---|---|
| ***Microcap PME (Ratio)*** | 0.74 | ***0.95*** | 1.15 |
| ***Microcap PME (Held at Cost)*** | 0.63 | ***0.92*** | 1.05 |
| ***S&P 500 PME (Ratio)*** | 0.77 | ***0.93*** | 1.18 |
| ***S&P PME (Held at Cost)*** | 0.68 | ***0.88*** | 1.14 |

The median fund in the sample performed slightly below the benchmarks (since median PME < 1), but the bootstrapping exercise suggests that the researchers cannot reject in general that the entire industry segment of market-rate-seeking impact investing funds perform the same as the index (true median PME = 1) above a 95% confidence level. Due to the high variability of performance and small sample size, the confidence interval for the PME is broad. A larger sample will be necessary to refine these calculations and to narrow the confidence interval further in order to make larger and broader claims for the industry.

37 Method 2 from the Methodology section.

38 Although WSII received survey responses from 53 funds, segmenting the data creates challenges in terms of sample size. For the confidence interval calculation, WSII required market rate-seeking funds to have submitted sufficient financial documentation to recreate verifiable cash flow information. Sixteen funds met this criteria for this calculation.

39 Using the original set of individual fund PME calculations, the bootstrapping exercise randomly recreated 1,000 new sets of data (replacing PME calculations and therefore allowing PMEs to be selected more than once).

# Discussion

## Summary

The marked increase in capital under management in the impact investing private equity industry created a corresponding increase in deals. This research study sought to determine what one might expect to happen to a company's social or environmental mission when impact investors seek liquidity in this wave of deals.

Although this analysis relies on a modest sample of 53 funds, fund managers appear to have ample discretion from their LPs to make mission-aligned choices when exiting companies. In the vast majority of cases, fund managers have the latitude to consider social or environmental missions in their investment decisions. Indeed, most report their legal documentation (e.g., Limited Partnership Agreements, Private Placement Memoranda, and side letters) even require such consideration. It seems that if exit decisions were simply left to fund managers, these missions might be well protected.

In practice, however, portfolio company boards of directors usually control exit decisions, and in companies with special shareholder rights, these decisions are made at the shareholder level. In either case, the WSII sample shows that fund managers have insufficient control to fully exercise the discretion that their fund's governing documents provide them, even when they include the voting power belonging to other investors who are aligned with their mission.

> **"Early findings provide no evidence to suggest that these mission-aligned exits draw depressed financial outcomes. In fact, the data show that mission-aligned exits in the sample can provide strong returns."**

Despite this, fund managers report an expectation that the mission would persist in 95% of their successful exits (i.e. 95% of successful exits are mission-aligned) – even though 67% of the exits had no contractual statement to pursue the mission (much less a legally binding one.) Notwithstanding the lack of either documentation or sufficient control to support mission-aligned exits, one might wonder what generates this optimism towards mission preservation.

Early findings provide no evidence to suggest that these mission-aligned exits draw depressed financial outcomes. In fact, the data show that mission-aligned exits in the sample can provide strong returns. Perhaps then, boards and shareholders of impact companies often do not find themselves facing a difficult decision between an economically or socially motivated exit, and therefore the strict dichotomy of strong returns versus strong impact may be unfounded.

Further examination of industry performance bears this out. Preliminary analysis demonstrates a gross internal rate of return of 12.94% for impact investments made by the survey respondents (with important caveats as to the valuation of unrealized investments). Early results indicate financial performance is comparable to a Russell Microcap index (PME 0.98) and to an S&P 500 index (PME 1.00) for the time period between 2000 and 2015. Impact investments in the sample, therefore, may be financially competitive with other equity investing investment opportunities. This financial performance may be why impact fund managers often assert that there is little inherent tension between profits and purpose.

**"...impact fund managers often use a pre-investment screening process to invest only in companies with products or services that are inherently impactful, making impact core to the investee's business model."**

This lack of tension may be driven by funds' use of an "embedded impact" strategy. In other words, impact fund managers often use a pre-investment screening process to invest only in companies with products or services that are inherently impactful, making impact core to the investee's business model. But absent contractual or governance protections, it would appear that fund managers and impact companies are making mission preservation largely reliant on the culture of the acquiring or controlling company. Company culture can be a powerful and enduring force, but it is reasonable to ask if there is ever really a product or service with mission so central to its value that it cannot be distorted or used contrary to its original intent.

## Implications

If we are to assume fund managers are accurate in their assessments of mission persistence, additional protections on social mission at the time of exit may be of limited effect. For impact investors at large, the research findings highlight the importance of the due diligence stage of the investment process – even as it relates to post-exit impact. During the pre-investment phase, for example, impact investors may increasingly consider the extent to which the momentum of a company's "embedded impact" may alone propel and insulate social performance.

While investors must be attentive to the due diligence process, a reliance on pre-screening processes rather than formal controls to maintain impact after exit may limit a GP's ability or motivation to scale impact. Just as the capital requirements of portfolio companies evolve over time, so too might capacity shortfalls related to social impact. GPs can avoid stagnation by catalyzing further development of impact by providing additional invested capital, management guidance, or other technical expertise. This approach can ensure that impact is not only "locked in" but also evolving along with revenue growth or market reach.

As previously discussed, the attribution of mission preservation to pre- rather than post-investment activities may be an indirect result of the limited controls investors retain when seeking liquidity: without majority control, an "embedded impact" strategy may provide social investors with the greatest traction in ensuring the long-term impact of their portfolio companies. However, the use of shareholder agreements or other contractual controls to codify social mission may effectively substitute for or bolster this approach, even when socially driven investors constitute a minority share. For example, minority shareholder protections such as right of first refusal or the requirement of a supermajority in decision-making could help to provide outsized influence to social investors at the point of exit, helping them to exert control over acquirer selection or dictate long-term institutional goals. Ultimately, a combination of controls, including pre-investment screening and shareholder agreements, can contribute to the preservation (and potential growth) of social or environmental performance.

However, broader questions remain about the investors' role in ensuring mission preservation. For example, some investors continue to question whether it is even a GP's purview to influence or control performance after they exited the deal. Alternative and innovative forms of financing may be more consistent with the goals of impact investors, for example, and some posit that the traditional 5-7 year time horizon for liquidity in the private equity model is insufficient, and that holding portfolio companies longer may allow them to mature and become large enough to dictate mission-related terms at the time of exit.

## Conclusion

The acceleration of deal flow in impact investing private equity – and the subsequent upsurge of realization events – continues to highlight the interplay between financial returns and social or environmental mission. As new investors enter the space, the demonstrated performance of these early investments may help to foster the continued growth of the field, particularly in terms of the market viability of mission preservation.

Impact funds in the sample that seek market-rate-returns demonstrate that they can achieve results comparable to market indices, while still reporting mission preservation in the vast majority of their exited investments. Investors will need more quantitative information to understand the causal mechanisms driving these double and triple bottom line returns, such as additional metrics on social impact pre and post exit, and further clarity on long-term impact. Ultimately, demand from LPs will drive the extent to which GPs are held accountable for the preservation of portfolio companies' missions. Additional research in the field remains crucial to providing both GPs and LPs with the data needed to understand the landscape and to potentially unlock additional capital in support of scalable impact.

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