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Impact investing: challenges of impact measuring

Although the term 'impact investing' only gained prominence as recently as 2008,[1] it has proven to be one of the fastest growing investment categories in the world, accounting for over $15bn in investments in 2015.[2] Impact investing can be defined as a type of investing that involves seeking financial returns through investments intended to generate measurable social and environmental impact via market-based solutions. As the impact investing movement has expanded, more and more major players in the investment community have dedicated capital to the impact space, including the establishment of dedicated groups within Goldman Sachs, BlackRock, TPG and Bain Capital (who notably engaged the former Governor of Massachusetts, Deval Patrick, to head its impact practice).

As more dollars flow into the impact sector, one of the greatest challenges facing the impact investing movement is defining what exactly the word 'impact' means. For some investors, the term 'impact investing' means accepting below market returns in the name of achieving some predefined impact, for example, the Calvert Foundation offers investors Community Investment Notes,[3] which offer a fixed, but below market, financial return while economically empowering communities worldwide. For other investors, the primary focus remains achieving at or above market returns, while having a secondary focus on the 'impact' created through such investment; some investors have gone so far as to argue that all successful investments create 'impact' under the assumption that growing companies inevitably hire more employees. Further complicating this issue is that some investors measure 'impact' on an individual investment level, while others measure it at the fund level.

Regardless of where investors and operating entities fall on the spectrum of defining 'impact', one common struggle among all impact investors is how to measure the actual impact of their investments. Despite the relative newness of this sector, already there are numerous players seeking to establish the premier methodology for measuring impact. Not surprisingly, two of the major forces behind the impact investment movement, the Global Impact Investing Network (GIIN) and B Lab, have each established standardised impact measurement tools. The GIIN,[4] a non-profit organisation that has dedicated itself to increasing the scale and effectiveness of impact investing, has established IRIS, a catalogue of generally accepted performance metrics that impact investors may use to measure social, environmental and financial success, and evaluate deals.[5] Similarly B Lab, a non-profit organisation and the driving force behind the benefit corporation movement in the United States, has established the GIIRS Rating, a 'rigorous, comprehensive, and comparable rating of a company or a fund's social and environmental impact'.[6]

In addition to the efforts to define impact in the US, a number of major players internationally are also focused on establishing impact measurement tools. For example, in the United Kingdom, the presidency of the Group of Eight (G8) taskforce has established the Working Group on Impact Measurement (the 'Working Group') to address the challenges of measuring impact. According to the Working Group, 'impact measurement is critical to the success and evolution of the impact investing market and that without it effective impact investing cannot occur… [it is] more than just measurement – it's about the future of the impact investing market and its tremendous potential to harness entrepreneurship, innovation and the power of private capital markets for public good'.[7]

Although standardised measurement tools play an important role in impact measurement, one challenge facing investors and operating companies is that each investment is unique and some investments creating 'impact' may not fit neatly into standardised measurement frameworks, such as IRIS and GIIRS. As a result, many impact investors are instead choosing to create specifically tailored measurement tools, such as impact scorecards, in lieu of using a more standardised measurement tool. For

example, the newly created $2bn impact fund Rise (part of TPG) in partnership with the Bridgespan Group has developed a proprietary impact assessment system that it hopes, if proven to be a successful measurement tool of the 'impact' of Rise's investments, could become a model for other investment firms.[8]

In addition to investors/investees agreeing upon how 'impact' will be measured in a particular investment, the parties must also determine how, if at all, those results will be utilised. In some cases, the additional deployment of capital and/or return of capital to investors are linked to the achievement of certain predefined impact metrics. One such example is social impact bonds – or 'pay for success' bonds – which tie repayment amounts to investors to the achievement of specified social outcomes. Another way to incentivise achieving impact is to tie the realisation of certain impact metrics to the payment of performance bonuses to management, in the case of equity investments, or to the reduction of interest rates (or waiver of other covenants) in the case of debt. Investors must be cautious, however, that when financial consequences are tied to the achievement of predefined impact metrics, investors maintain audit rights or impact performance is objectively verifiable. Other investors/investments take a softer approach, and they simply require the funds or portfolio companies to provide periodic reporting on the 'impact' being achieved, similar to how many traditional investors require financial reporting from their target companies.

Further complicating the measurement of 'impact' in impact investing is that fund investors, direct investors and entrepreneurs are increasingly demanding evidence of 'outcomes' of investments rather than more straightforward 'outputs'. Unlike investment outputs, which 'are tangible, immediate practices, products, and services that result from the investment activity', investment outcomes are 'changes, or effects, on individuals or the environment that follow from the delivery of these practices, products and services'.[9] Often 'outcomes' take years to materialise, if at all, and 'success' may be difficult to measure. Moreover, in some cases, it may be difficult to establish a correlation between the investment and the ultimate investment outcome. For example, although a correlation between solar lanterns (portable light-emitting diode (LED) lanterns that can typically provide light for four to eight hours, replacing polluting and inefficient kerosene lanterns and supplying basic lighting) and improved health may seem to be intuitive, those healthy benefits prove to be very difficult to prove on a per transaction basis.[10]

In addition to the overall challenges facing the impact investing sector, lawyers face a number of unique challenges in drafting the agreements governing these impact investments, including that they must clearly articulate how impacts will be measured and utilised at the outset of an investment, even in situations where the investment parties may not fully appreciate what the investment outputs will be, let alone the outcomes. Moreover, in certain instances, an investment may produce impactful outputs that were not contemplated at the investment's outset. To address this problem, some impact transactions are now including covenants allowing – or, in limited circumstances, requiring – parties to periodically re-evaluate impact measurements and, if necessary, the ability for parties to renegotiate reporting obligations and financial terms. To be drafted accurately and reliably, the covenants and provisions governing the measurement and utilisation of impact metrics, particularly in heavily negotiated deals, have the potential to result in significant third party costs (consultants, lawyers, etc), a cost that some investors may not be willing to make, particularly in transactions in which the achievement of impact – rather than financial performance – is the primary focus as many of those investors have already accepted below market returns in the name of achieving impact.

Investments that can both make money and do good are an attractive proposition and the main reason why the impact investing sector is thriving. In order to ensure the long-term viability of impact markets, and avoid the 'greenwashing'[11] of the impact sector and dilution of the impact community's noble mission, impact goals will need to be clearly defined and the achievement of those goals will need to be accurately measured.

Notes

1 Short Guide to Impact Investing, Case Foundation http://casefoundation.org/wp-content/uploads/2014/09/Short-Guide-Oct2015-Digital-FINAL.pdf accessed 18 January 2017.

2 Annual Impact Investor Survey 2016, dated 18 May 2016, The Global Impact Investing Network https://thegiin.org/knowledge/publication/annualsurvey2016 accessed 16 January 2017.

3 See www.calvertfoundation.org/invest accessed 16 January 2017.

4 Goodwin Procter, the law firm at which the authors practice, is a member of the GIIN.

5 See https://iris.thegiin.org/about/faq accessed 16 January 2017.

6 See http://b-analytics.net/giirs-ratings accessed 16 January 2017.

7 Measuring Impact, Subject paper of the Impact Measurement Working Group, September 2014.

8 Andrew Ross Sorkin, 'A New Fund Seeks Both Financial and Social Returns' *New York Times* (New York, 19 December 2016) www.nytimes.com/2016/12/19/business/dealbook/a-new-fund-seeks-both-financial-and-social-returns.html?_r=0 accessed 16 January 2017.

9 The GIIN, *Impact Measurement in the Clean Energy Sector*, 5.

10 *Ibid.*

11 See n 7 above.