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What To Know About PE's Penchant For Impact Investing

By **Benjamin Horney**

Law360 (November 19, 2018, 2:41 PM EST) -- With private equity firms increasingly interested in making so-called impact investments, which seek not only strong returns but also positive societal benefits, it is vital that attorneys get up to speed on the practice and the reasons for its rising popularity so they can successfully assist with the related legal work.

Impact investing has been around a while, but the private equity industry deciding the practice could be beneficial for business is a relatively recent development, especially since the PE industry is typically laser-focused on the financial bottom line. However, over the past several years there has been growth in private equity players focused on making impact investments, and attorneys that have done significant work in the space say the practice is only growing in popularity.

"We have seen a significant uptick in both PE clients that are interested in pursuing impact investing, as well as in the demand from institutional investors and endowments for strategies that more directly seek to achieve measurable, beneficial social or environmental change," said Peter Gilman, a corporate partner with Simpson Thacher & Bartlett LLP.

The growth of the impact investing industry is illustrated in the results of this year's eighth annual Impact Investor Survey, released by the Global Impact Investing Network, or GIIN. The survey included responses from 229 organizations that in total manage about $228 billion worth of impact investing assets. About 50 percent of the respondents made their first impact investment within the last 10 years, and of the one in three respondents that do both impact and conventional investing, roughly 84 percent said that over the last three years they have demonstrated greater commitment to measuring and managing their impact.

Those numbers jive with what many attorneys have noticed when it comes to increasing client interest in impact investing, according to Carolyn Houston, a corporate associate with Simpson Thacher.

"Many of our PE clients with flexible capital are currently making impact and sustainability investments through their existing funds to obtain a toehold in the space, while others are pursuing the launch of dedicated funds or strategies to achieve positive long-term change in a manner that does not sacrifice financial returns," she said.

Because impact investments aim to make some kind of measurable improvement to the world — such as helping work towards mitigating the effects of climate change or providing affordable housing in lowincome areas — there are issues that must be taken into consideration when putting together the related legal documents. Sometimes a regular private equity fund can have impact investing goals built into its framework, but there are other cases where separate investment vehicles dedicated to the practice are necessary, and it can vary greatly depending upon the specifics of what a client actually wants.

“If a client is focusing on the societal impact of acquiring an asset or a diligence finding, our job is to put that consideration in the context of the transaction, identify any available solutions, and deliver them so that the client is able to execute on their strategy,” said Kfir Abutbul, a private equity partner with Paul Hastings LLP.

One of the first things an attorney should focus on when working with a client that has expressed an interest in the space should be determining, in conjunction with the client, what type of impact investor they want to be. There are three general categories of impact investors, according to Suz Mac Cormac, a partner at Morrison & Foerster LLP and chair of the firm’s social and impact Investing practice: impact-first, investment-first, and catalyst-first.

“Impact means a lot of different things to different people,” said Mac Cormac, who has been working on these types of investments for clients since 2001, when the practice was not yet called impact investing.

Impact-first investors are those mainly focused on maximizing the positive social or economic impact of their investment, meaning financial returns are a secondary consideration. These types of investors essentially treat their investments as a form of humanitarianism, but instead of providing grants they seek to make investments with little or no concern about returns. The legal work for that type of impact investing is typically done pro bono, Mac Cormac explained.

“It’s kind of like philanthropy 2.0,” Mac Cormac said. “There’s a goodness sheen that comes with doing it.”

Investment-first investors are those that focus on receiving strong returns from their investments, meaning that while the investments will look to do some good, the positive social benefit is not as important of a factor as it is to impact-first investors.

Finally, catalyst-first investors are those that have interest in building up the overall impact investment industry and contributing to making the practice more common, and they usually consider both the social impact and financial return of an investment to be of equal importance.

Those private equity clients that have yet to consider the practice would likely point to the fact that they are focused on generating strong financial returns for their limited partners, but one look at the relevant results from the GIIN survey shows that such an excuse is actually wearing thin. About 82 percent of those surveyed by GIIN said that their impact investments have met expectations for impact, while 76 percent said their impact investments have met expectations for financial performance. Roughly 15 percent, meanwhile, said that their impact investments have actually outperformed their financial expectations. Further, 86 percent said that they are motivated to make impact investments as a response to demand from clients.

“There’s a belief by many impact investors that focusing on environmental and social goals will yield higher returns and profitability,” Mac Cormac said.

Since it's clear that impact investing is on the rise, and that the practice actually has the potential to generate strong returns in addition to positive effects on society, attorneys should be educating themselves today on the specific areas impact investors are most interested in so that they can put their hand up when a client comes looking for someone capable of serving as counsel for impact investment-related activities.

"What's exciting about the impact investing space is the breadth and depth of the types of investment opportunities that it affords," Gilman explained. "Not only are areas like water treatment and environmental initiatives in need of substantial long-term capital, but so too are areas like education funding, microfinance, affordable housing, public infrastructure, cleantech and health care. Each of these areas requires substantial specialization and expertise, and for that reason it is common for PE firms and other impact investors to partner with experts in each sector or field to help evaluate opportunities and measure the anticipated long-term impact of their capital in an objective and quantifiable manner."

--Editing by Kerry Benn and Pamela Wilkinson.

This is the first in a two-part series of stories on the private equity industry's increasing interest in impact investing and the unique legal work that can be associated with the practice.