KEYNOTE INTERVIEW

Verifying impact

As the impact investing space continues to expand, stakeholders are increasingly seeking evidence that GP claims about impact hold true, says BlueMark's Christina Leijonhufvud

With so much capital now being directed towards impact investing, there is a growing need for GPs to adopt a rigorous and verifiable approach for generating impact alongside financial returns.

Indeed, two-thirds of respondents to the Global Impact Investing Network's 2020 survey of impact investors identified impact-washing as the greatest challenge facing the market over the next five years.

It is a common complaint among market observers that the proliferation of impact and ESG frameworks, metrics and standards only adds to the confusion. But is progress finally being made towards a common language and set of processes? How can investors be confident that GPs are actually focused on impact? BlueMark, an impact verification business, was founded in January 2020 to address these types of questions and to meet the growing market demand for expert, third-party verification of investor impact management practices and performance. *Private Equity International* spoke to Christina Leijonhufvud, CEO of BlueMark, to explore the evolution of impact verification and gauge how the market is charting a path toward greater clarity, transparency and accountability.

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Q How is impact measurement and management evolving among GPs?

We have seen enormous progress over the past few years. There is now an expectation that GPs using the impact label will have in place a robust system for managing and measuring impact. The market is signalling that GPs need to have strong practices and processes that truly integrate impact considerations through the investment lifecycle.

This is a fairly recent evolution. In the early days of impact investing, there was almost a singular focus on getting to a consensus on a standardised set of impact metrics. Impact performance measurement is tricky – it is

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difficult to boil down impact (including both positive and negative impacts) to a discrete set of metrics. Different GPs use different metrics to report their impact to investors, depending on their specific investment strategy and the context-specific features of their investments – for example, carbon emissions reduced versus quality jobs created. As of yet, there is no universal framework for comparing and benchmarking such disparate metrics.

Fortunately, widely accepted standards now exist for how GPs should embed impact considerations into each stage of the investment process. This is something that our sister company, Tideline, has been advising GPs on for years, helping design impact strategies and develop impact management systems. As impact management has become increasingly codified through voluntary market standards, so too has interest in the independent verification of GP practices.

The real game-changer was the launch in April 2019 of the Operating Principles for Impact Management because they articulate a solid threshold standard for impact management, with Principle 9 specifically requiring independent verification. This provided the impetus for the launch of BlueMark.

Q Who is driving this evolution? Are LPs now demanding this or are GPs taking the lead?

It's a combination of both. LPs are asking tough questions during due diligence to determine whether a GP is truly committed to impact, and they increasingly want a third-party opinion regarding both a GP's impact management practices and impact performance. You also have the regulators starting to step in to hold GPs accountable. Despite the explosion of ESG and impact fund launches, GPs are acutely aware of the danger of accusations of impact-washing and greenwashing.

Impact GPs want to ensure they are labelling their products appropriately and credibly. One way to earn this credibility is to join the more than 140 signatories to the Impact Principles, who are all committing to greater transparency and clarity as to what constitutes a legitimate impact investment strategy.

Q It's clear that progress is being made, but there is still the issue of an alphabet soup of metrics, frameworks and standards. Where are you starting to see more clarity?

There has been tremendous progress toward setting industry standards, especially around impact management, thanks to the efforts of organisations like the Impact Management Project. These standards apply across asset classes, but are particularly relevant in private equity where clear best practices exist, from investment origination through to exit. The rapid adoption of these standards and practices has made it easier for investors that may find the impact investing space confusing or intimidating.

However, there remains work to do around impact performance measurement. The standards are not there yet, although we do have the bones in frameworks such as IRIS+, HIPSO [Harmonised Indicators for Private Sector Operations], the Sustainable Development Goals and the target indicators that sit behind these. A multi-stakeholder drive is underway towards producing high quality, reliable and verifiable information and performance reporting, but a common vision that satisfies all stakeholders has yet to be fully developed.

Q What will it take to get there with performance reporting?

It's an industry-wide work in progress. For example, we recently received a grant from the Tipping Point Fund on Impact Investing to work on what constitutes verifiable performance reporting, while initiatives such as SDG Impact establish a set of standards that take impact management and measurement practices a step deeper to encourage stakeholder engagement. The IFRS Foundation is making moves to standardise sustainability reporting for corporates and investors. Momentum is clearly building, but there are still hurdles left to clear before we get to a near-universal standard.

There is also a greater understanding that performance reporting is not just about metrics, but about providing information that is both balanced and context-relevant while driving for reliability and comparability. Our clients, for example, have been asking us to perform diagnostics on their performance measurement and reporting. There is a race to the top among GPs to align with best practices.

Q What have you learned from the verifications you have carried out so far?

To date, we have completed more than 50 verifications on impact management practice and performance reporting. We designed our verification services to impart real insights and learning benefits to our clients, not as a check-the-box, compliance exercise, so the GPs that come to us are committed to improving. We have only had one client walk away from our verification process because they were not looking for a truly rigorous verification.

The quantity and quality of data we have collected allows us to group our verification clients into what we call 'Practice Leaders' (those in the top quartile) and 'Practice Learners' (those in the bottom quartile).

For example, the vast majority of our clients align their strategies broadly with the SDGs, but fewer than half (the 'Leaders') go the extra mile to align with the 169 underlying SDG targets. Around half have gone some way to aligning compensation with impact performance (although this is mostly through bonuses), but just 3 percent (the 'Leaders') tie carry to impact performance. These are significant differences, and these are exactly the kinds of insights that can help LPs separate the wheat from the chaff.

Q Where is there a need for improvement?

We are starting to see a greater focus on stakeholder inclusion as an essential part of impact management and measurement, so that workers and communities, for example, are involved and engaged in the decision-making process. However, I would say this is still a frontier practice at this stage.

We also currently see little upfront exploration of the negative impacts of investments. Every investment has both positive and negative impacts, but investors are usually only focused on the positive impacts. Negative impacts need to be better managed and GPs need to be explicit about what these are and how they are incorporated into the decision-making process. This is a best practice that all signatories to the Impact Principles are expected to follow.

Q How are GPs using verification?

Some GPs are understandably nervous about what we might uncover and they recognise that it is not necessarily a comfortable exercise. But most see the benefits as BlueMark helps provide a roadmap for improvement.

Our mission as a firm is to "strengthen trust in impact investing" by bringing more accountability, discipline and comparability to the industry and by raising the bar of best practice through verification.

So, we conduct a thorough evaluation of strengths and weaknesses, including a gap analysis and ratings of clients on a four-part scale (advanced, high, moderate, low) according to their degree of alignment to the Impact Principles. This is important because that rating creates a benchmark that GPs can then use to see how they stack up against peers. LPs can also use this benchmark in their due diligence of GPs. ■

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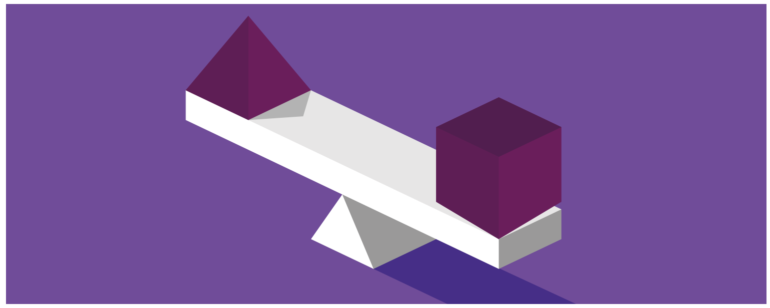

Q What future developments do you see in this space?

We will see greater clarity around what differentiates an impact product from an ESG product. The Sustainable Finance Disclosure Regulation will help create more confidence in the impact label because only funds that have impact as an explicit strategy will be able to classify themselves as Article 9 funds. GIIN's impact classification system will also help validate what really deserves to wear the impact label.

Proper labelling of strategies is in sight. BlueMark's sister company, Tideline, recently published a 'Guide to using the impact investment label' that explored the differences between ESG, thematic and impact strategies based on the degree to which they integrate intentionality, contribution and measurement into the investment process. This is a framework we've used successfully with clients in the past, although we acknowledge there is still more harmonisation needed to get to universally accepted terms and definitions.

Related to this, I think we are due for a shake-out in the ESG market. There is growing scepticism as to whether the roughly $30 trillion in ESG funds is actually contributing to real-world outcomes. We need greater clarity around which segment of the market is having real impact and which is managed purely for financial risk and return objectives. Verification can play an important role in identifying the real impact players, thereby separating the 'Leaders' from the 'Learners' and strengthening trust in the overall market.