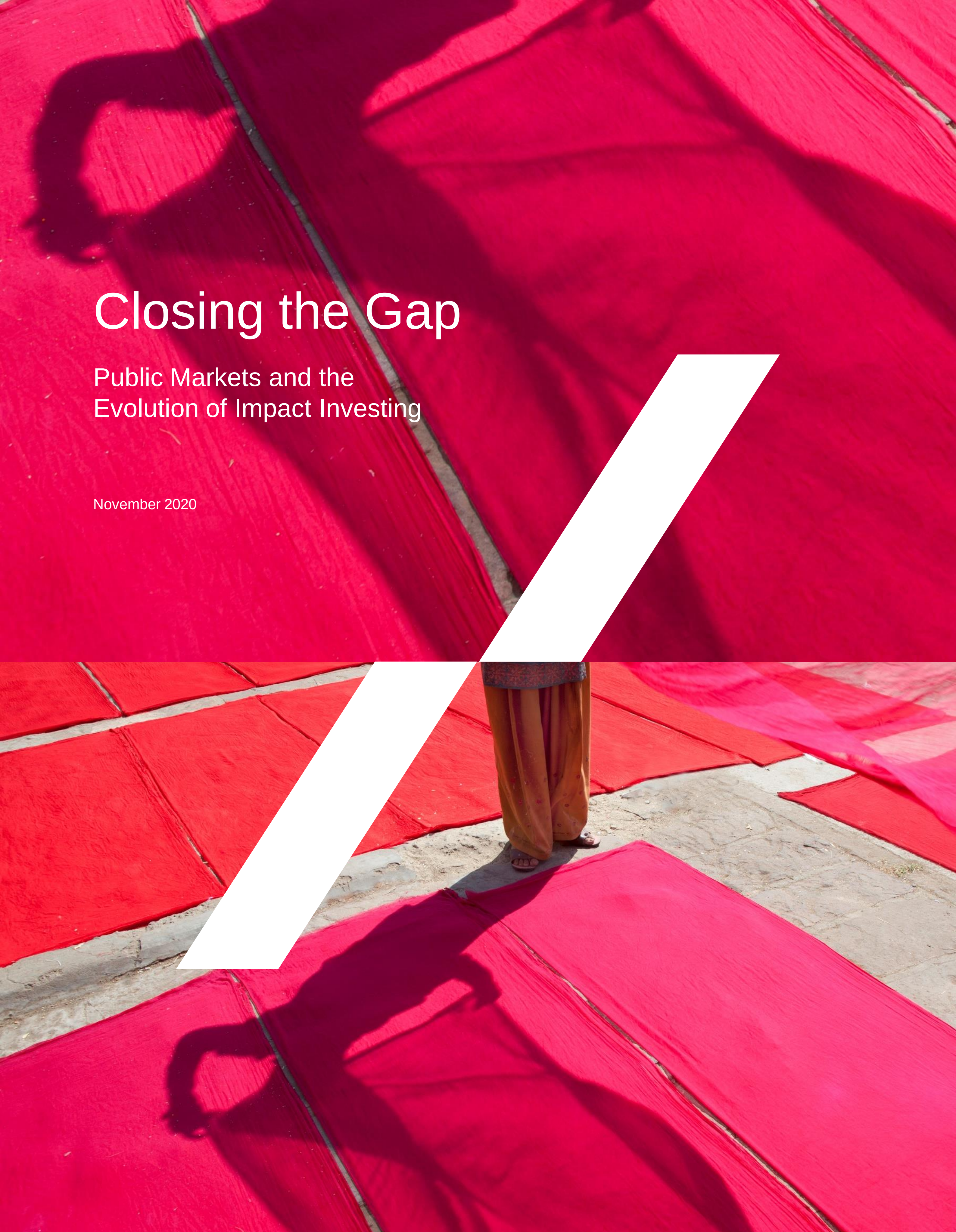

Closing the Gap

Public Markets and the Evolution of Impact Investing

November 2020

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Regnan

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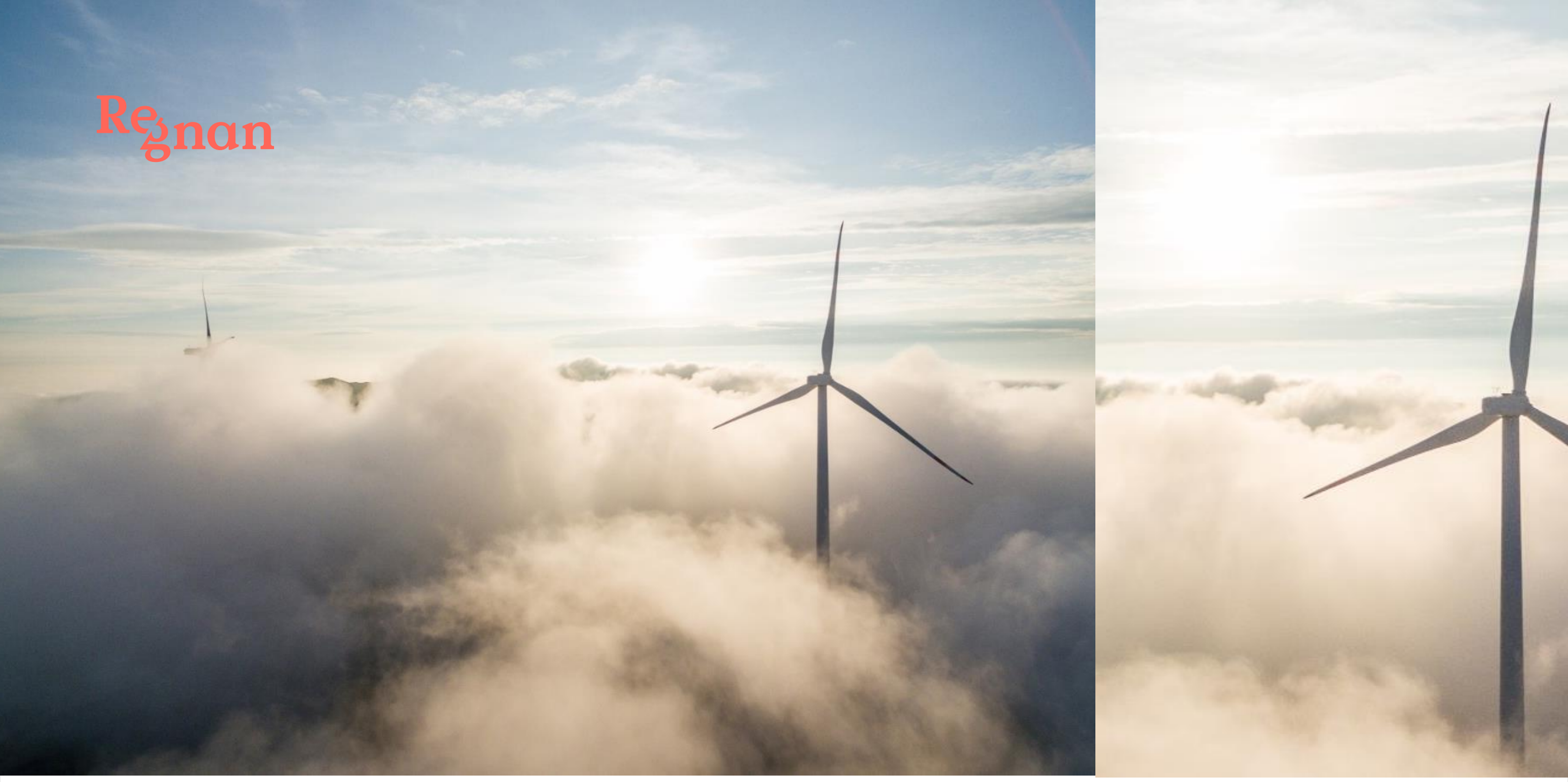
REGNAN is a responsible investment leader with a long and proud heritage providing advice and insights on important environmental, social and governance issues.

For more than 20 year our pioneering analysis has changed the way investors and businesses think about value creation and their wider responsibilities to society.

Building on that expertise, Regnan has now expanded its capabilities into responsible investment funds management, backed by the considerable resources of Pendal Group.



Closing the Gap: Public Markets and the Evolution of Impact Investing

Solving today's global environmental and social problems demands a combination of money, long-term thinking and innovation. We believe that the United Nations' 17 Sustainable Development Goals provide a great framework for addressing these problems. However, the aim is to meet the SDGs in less than ten years – the deadline is 2030. It will also be extremely expensive. According to the UN's Sustainable Development Solutions Network, there is an annual gap of $2-3 trillion between current public and private-sector spending on the SDGs – a gap that will widen as we near the target year, if we don't make inroads in closing it.[1]

This massive gap can only be closed through a broad mix of funding sources. Governments, foundations, and impact investors in both private and public markets all have an important role to play, because none of these groups has the scale to achieve success on its own.

When it comes to public equities markets specifically, we see a huge opportunity in helping the world, and in making a return by doing so. Just as some SDG targets are best met by governments, foundations or smaller private companies, some are particularly well met by investors in listed equities.

Take healthcare, for example. To help fulfil the targets for SDG 3, Good Health and Well-Being, companies supplying solutions need considerable capital. They must often spend a great deal on research & development to create innovative solutions, that push the boundaries of what is considered scientifically possible. They also need the money to scale up production, to the point where they can make a sufficiently large contribution to solving large global health problems. This includes creating broad access to therapies. Listing on public markets is often an important step in providing the necessary capital and scale. In healthcare, this often happens at an earlier stage of a company's lifecycle, relative to other industries. Innovative healthcare companies depend on heavy upfront R&D spending to deliver breakthroughs and manufacture the resulting therapies in sufficient quantity. Furthermore, capital intensity is increasing as we shift towards more effective and targeted biological treatments. If commercialised successfully, these ultimately lead to better patient outcomes than the current standards of care. Such large amounts of capital are often only accessible through a public listing.

In applying impact investing to public equities, we believe that the core tenets of impact investing, first established in private markets, need to be retained: the search for investments with the intention to generate additional positive impacts, alongside a financial return. However, this concept needs some adaptation so that investors can maximise their potential to deliver impact, when investing in listed equities.

[1] https://www.unsdsn.org/sdgfinancing

Intentionality

Impact investors' mission is to achieve a financial return by investing in companies with the potential to produce a specific positive environmental or social impact. However, unlike private equity investors, public equity investors do not enjoy significant control over the businesses they invest in. They do not provide financing for specific projects either, as bond investors might do. Investors like us cannot transmit our intention to generate a positive impact by directing and shaping the company's mission. For this reason, we must look for companies already on that mission, that share our intentions.

Genuine intention to create a positive impact encompasses more than just an eye-catching mission statement, or deriving a certain proportion of sales from a positive impact solution. As long-term owners of the businesses which we invest our clients' capital in, we seek to understand what drives the company's culture, and how it plans to execute its mission as part of a long-term strategy. This requires us to understand not just what impact the company is making today, but how central this impact will be to the company's mission in the future. For this reason, we have to interrogate management about their long-term vision for the firm, study its past, and ensure that we can garner quantitative as well as qualitative proof that management is walking the talk.

Additionality

Impact investors also want to show that their investment creates an additional positive impact that has made a tangible difference to lives.

We have to consider additionality in a different way from private market and project finance impact investors. This is because as buyers of equities in secondary markets rather than primary capital providers, we cannot claim that our capital was solely responsible for the generated impact.

However, we should not underestimate the importance of those flows of secondary capital as an incentive system for companies.

The influence of existing shareholders on corporate behaviour is often great, as in most cases company charters and corporate law emphasise, rightly or wrongly, the primacy of shareholder value maximisation as the key corporate objective. If a critical mass of shareholders allocates capital based on a company's social and environmental impacts, this unleashes a powerful mechanism for companies to direct more of their capital spending, R&D investment and recruitment to divisions of their businesses creating solutions, rather than those contributing to the problem.

We therefore believe that the concept of additionality should be applied on a company level, rather than on an investor level. A company's additionality is ultimately the positive impact driven by that company, which would not have occurred without the existence of this company and its particular solution to an environmental or social problem. This may have been driven by R&D that has allowed them to deliver a product with unique attributes, and an ability to solve a problem in a different way from their competitors. They may have built a business to provide access to education or basic financial services to an otherwise underserved population and reach areas that other companies have, either unknowingly or intentionally, overlooked.

As long-term investors, we seek to forge strong relationships with management teams. We also work with them to minimise any negative impacts that result from their business, or the wider value chain in which it operates. This focus on collaborative engagement allows us to deliver additional positive impact by working with management to reduce the business's negative externalities. We might feel that a recycling equipment maker can do more to reduce the carbon impact of its suppliers, for example. In such a case, we would discuss the feasibility of setting targets for the company to decarbonise its supply chain.

We identify companies that are on a mission to address environmental and social problems with a unique solution, by using our proprietary Regnan SDG Taxonomy.

The SDG framework

In seeking solutions, we need a framework to identify problems that need solving. This is where we find the SDGs useful. Policymakers believe these are the goals society must focus on if it wants to achieve a widespread prosperity in a sustainable way. Taken at face value, the 17 SDGs are vague. Goal 12, for example, is Responsible Consumption & Production. For this reason, we prefer to concentrate on the 169 targets linked to the goals, since these are more informative about the specific issues that need to be resolved. For example, Target 12.5, one of ten targets linked to Goal 12, is a little clearer: “By 2030, substantially reduce waste generation through prevention, reduction, recycling and reuse.”

This is where, as specialists in listed equities, we must be realistic about what we can do, and what’s best left to others. We can think of two different investable solutions for Target 12.5 – “waste collection, recycling and reuse” and “logistics and food preparation”. However, some other targets don’t yield solutions that can be met by public listed companies. Target 12.8 is about giving people the relevant information to lead sustainable lives. That’s probably best achieved by NGOs and governments; we are yet to find a company that has uncovered a market-based solution to this specific target. Some of the targets for Goal 2, Zero Hunger, are probably best met by private investors for the time being. There are some great commercial ideas, but most are small business areas within global conglomerates, or are still at the venture capital stage.

We call this overall framework the Regnan SDG Taxonomy. It seeks to map products and services that exist to meet the SDG targets, understand their scope to scale, and learn about the companies that sell them. Along with our colleagues in the Regnan Engagement, Advisory and Research team, we have so far identified more than 150 investable solutions to 55 of the SDG targets, and we continuously seek to expand and grow this taxonomy, as new, innovative solutions are being delivered by newly listed and established companies all the time.

Measurement

A private markets impact investor that has a majority stake in a company and seats on the board might fund capacity expansion. With direct involvement in this project and access to management accounts, it should be fairly plausible for the investor to acquire data that helps articulate the additional impact that this project has generated. As investors in public equities, we don’t have access to the inside information enjoyed by a private markets investor. We don’t have access to specific project outcome metrics that need to be published, as is the case for social and green bonds. Consequently, there’s still a dearth of the information about outputs and outcomes that allows us to measure positive impacts and track these over time. As a result, we use our engagement to encourage management teams to improve their disclosures about the impacts that their products and services are driving or enabling. At the same time, we seek to understand which currently available inputs, outputs and outcomes allow us to understand the scale of impact that is being delivered – and perhaps more importantly, how this is increasing over time.

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Impact investing with integrity in equities is both essential and feasible

To conclude, the world needs impact investing in public equities, in order to deliver on the SDGs, but investors in this field must preserve the core tenets of impact investing. We are on a mission to do two things. We want to preserve these concepts, and the integrity that gave birth to impact investing. At the same time, we offer a solution that allows for additional positive impacts to be delivered at scale, through a platform accessible to any investor.

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