KEYNOTE INTERVIEW

LP appetite grows for ESG solutions



Responsible investment is now a priority for LP portfolio construction, and managers are responding with supply to meet that demand, say HarbourVest Partners' Natasha Buckley, Carolina Espinal and Ian Lane

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Q What are you currently observing in terms of demand for ESG solutions among the LP community?

Natasha Buckley: Sustainability and impact investing has become a critical element of portfolio construction across asset classes. A lot of LPs come to us as they are doing market research and thinking about how they will allocate to ESG and sustainable strategies in private markets. We recently conducted a survey of 130 of our LPs, half of whom are based in Europe, and found that 72 percent plan to increase their allocation targets to sustainability and impact investing in the next two years. Within that, three-quarters already include private markets in those allocation plans and a further 19 percent plan to include private markets in those strategies going forward.

LPs are actively looking for solutions as they are under-committed according to the impact investing targets they have set. We are watching the volume of demand and gauging what the supply looks like. LPs are looking to deploy large sums of capital, so they need scalable opportunities and want to work with established managers with diversified, high-performing portfolios.

We asked the LPs that we surveyed whether it was important that their allocation to sustainability strategies was through an impact fund vehicle or whether it could be through a fund that isn't strictly defined as impact. Only about 25 percent of LPs found an impact fund was decision-critical, while for others it was important, but not vital. That was important to us as we thought about our own strategy for responding to this investor demand, and why we think co-investment is the right solution at this stage.

What is your view on how co-investment strategies can be used in support of positive impact?

Ian Lane: A co-investment strategy provides investors access to a broad and diverse range of impact opportunities because it deploys capital at the asset level, rather than restricting allocation to a limited range of impact funds currently available. Over the course of 2021, we saw a substantial amount of dealflow across our co-investment platform and reviewed about 1,000 investment opportunities.

We launched the HarbourVest Stewardship Initiative to create portfolios of companies from our direct co-investment and real assets dealflow that we believe make a positive impact and meet our standard underwriting criteria. Based on our assessment of current dealflow, we see an opportunity to provide purified exposure to a portfolio of impact companies without making a sacrifice on the return profile. We call it the Stewardship Initiative because we are directing capital flows with purpose and work actively with our GPs to increase the number of eligible deals at the top of the funnel.

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Carolina Espinal: The impact scene is quite fragmented when it comes to well-established, credible managers. There is so much demand, but a limited universe of experienced GPs delivering on returns. Today, we are tracking about 45 impact or ESG-focused managers, alongside a growing group of managers that would not necessarily define themselves as impact, but which are oriented towards industries focused on sustainable solutions, such as traditional healthcare.

On the co-investment side, there is a clear line of decision-making around what qualifies and what we mean by stewardship at a company level. That is harder to do at a fund level today because the definition differs depending on different managers' ideas and how they want to pursue that mandate.

What investment themes is HarbourVest focused on in this regard?

NB: We have identified five themes for the initiative, specifically health, education, environment and sustainability, community and inclusive finance. We already see a substantial amount of dealflow in these areas, and have also identified sub-themes within each, such as renewables within the environment and sustainability.

The LP survey that we conducted told us that the top two investment themes for impact allocations are energy transition and alignment with the UN Sustainable Development Goals. We map out when Stewardship Initiative investments correspond directly to the underlying targets of the 17 SDGs to capture contributions to this vital effort.

We have developed a process for scoring opportunities that come to us so we can rigorously identify stewardship investments that meet our positive impact criteria. Our scorecard aligns with the Impact Management Project framework, scoring on various factors, including the strength of the positive outcome for beneficiaries, whether the market is currently underserved, and so on. We apply this analysis on top of our standard ESG risk assessment of the deal and ESG evaluation of the lead sponsor to check that the positive impact thesis is well-supported.

IL: Our investment thesis is the same across our firm's platform, focused on targeted returns and investment selection rigour, while also focusing on sustainability themes and getting access to experienced managers. We undertake the same due diligence and evaluation for impact assets as we do for other assets. This is enhanced by working with specific GPs that we think are strong in the sectors where we focus.

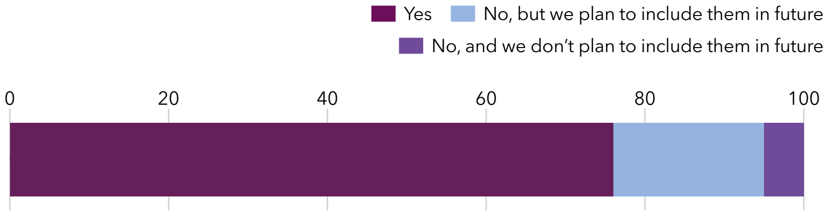
Effectively, we are looking for a substantial proportion of the business to be directed to our stewardship strategy and we want to be able to evaluate how those stewardship goals are being met, prior to and during our investment.

How much dealflow are you seeing that meets your stewardship criteria?

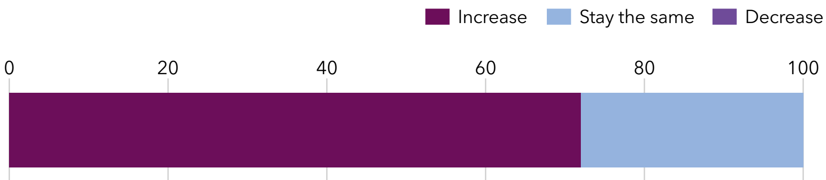
IL: We have been really pleased by the amount of dealflow. Having dedicated capital and a focused strategy has enhanced our sourcing efforts, so we are spending time with GPs that are aligned with our stewardship initiative and talking to them about our investment themes.

While we already have a good level of activity to build a diversified portfolio, our focused dealflow has increased since we launched the strategy. As we look forward, we think there is a good supply of opportunities coming through to meet growing LP demand.

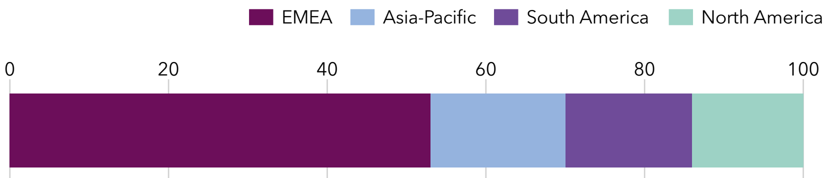
Are private markets within the scope of your target? (%)



Do you plan to change these targets within the next two years? (%)



Location of respondents' headquarters (%)



Source: HarbourVest Partners' ESG, Sustainability and Impact Investing Survey 2021

We have been investors in healthcare, education and renewable energy for a long time, and we are seeing a lot of deal opportunities around new technologies that can enhance access to those resources. We have also been investing in digital finance for several years and, with the combination of internet connectivity and growing software platforms, we are now seeing an opportunity to meet demand for inclusive finance in underserved geographies and population segments.

Technology underpins each stewardship theme – which makes sense because it drives access, affordability and scale. That is consistent with what we see across our broader portfolio and investment activities.

Q What are you seeing happening on the GP side around impact strategies and reporting on ESG metrics?

CE: A decade ago, we saw managers develop in-house operational expertise on areas such as cost management. We also saw forward-thinking managers bring in ESG professionals, and over the last few years that focus on ESG resourcing has really intensified. The sophistication and specialisation around impact themes has led to GPs having to think about how to integrate impact in their existing strategies or even further raising dedicated impact focused extension vehicles. After years of implementing solid ESG tracking processes and building out the necessary internal infrastructure, managers have harnessed their impact knowledge and are actively reshaping the dealflow we are seeing now.

On ESG reporting, the information we are getting from GPs is increasing in quality. We are seeing more in-depth ESG analysis in due diligence materials and we have also seen an evolution in regular ongoing reporting in terms of tracking impact and selecting KPIs for portfolio companies. We are also seeing some GPs start to link carried interest to impact targets, where a portion of the rate of carry becomes available to the GP only if impact and sustainability objectives are achieved.

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>
> **CAROLINA ESPINAL**

NB: GPs all have bespoke approaches, but we are seeing a real drive towards convergence, supported by automated platforms. That is necessitated by regulatory pressures and pressure from LPs for detail across their portfolios. There is a real risk that ESG reporting is becoming unmanageable, and in response to that there are a number of initiatives to drive convergence – including the development of the International Sustainability Standards Board by the International Financial Reporting Standards Foundation – which we welcome.

We see LPs taking an increasingly collaborative approach to disclosure through forums such as the Institutional Limited Partners Association and the Principles for Responsible Investment, and we are hoping we will move away from multiple reporting standards from different regulators towards a more harmonised system and a meaningful approach to fund labelling. ■

Natasha Buckley is vice-president and head of ESG; Carolina Espinal is managing director, primaries; and Ian Lane is managing director, direct co-invest at HarbourVest Partners