Meeting the capital challenge within impact growth equity

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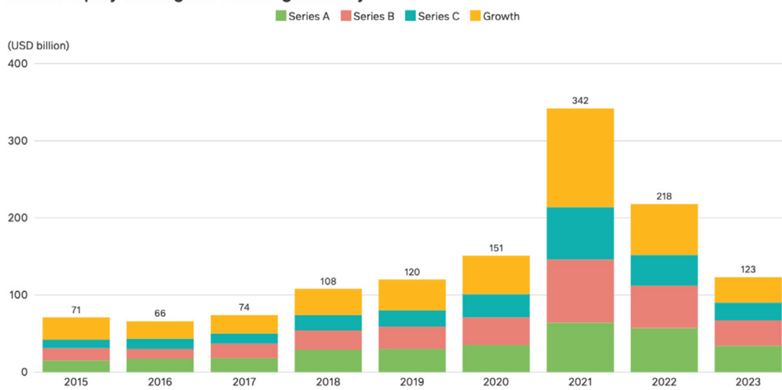
Private equity investors increasingly are seeking to make a positive impact within their investments. For the businesses involved however, there is a problem: availability of late-stage funding. In this article, we explore the reasons why.

Impact growth investing continues to grow in investor interest. Market research firm Brainy Insights[1] predict the size of this market will more than double to $10bn over the next decade. This strong growth is not surprisingly given strong drivers such as government policy, more robust measurement tools and institutional investors increasing allocations.

For private equity investors, there is a clear attraction – aligning their return and values objectives whilst also supporting businesses seeking to make a positive social and/or environmental impact. This is particularly relevant to pension plan managers with private equity, an important component in endgame planning and potentially delivering superior long-term returns.

The attractions may not end there however. Diversification is often an objective and impact growth equity, typically with a focus on small to mid-cap stocks, can diversify portfolios within larger equity portfolios with a large-cap bias. Longer holding periods typical within private equity can provide further diversification benefits.

However, there is an issue impeding the growth potential of this investment area. There exists a fund gap for these businesses, specifically during their growth or scale-up phases.



Source: M&G Investments, March 2024

The cause can partially be linked to venture capital (VC), a traditional provider of capital at these funding stages. High interest rates, uncertain economic environment and a steep decline in IPO activity (the main VC exit route) have acted as a deterrent for greater VC participation.

Higher rates are also a factor for infrastructure investors, another important source of funding for these enterprises. Infrastructure investment is sensitive to interest rates given the importance of cash-flow, with higher rates negatively impacting valuations. Retrenchment by both VC and infrastructure equity investors matters as businesses require the key attributes these investors offer: scale, capital availability, and risk appetite (VC).

Mind the gap

The significance in this funding gap lies in the fact it has typically funded operational build-out, marketing support, market expansion and M&A for PE businesses. This reduction in growth/scale-up stage funding is crucial as it is often at this stage investor value is accelerated and any shortfall can hamper investor returns and stifle vital innovation.

One of the largest affects can be seen within energy transition. Capital intensive, these business depend on late-stage funding to bring to market infrastructure and innovative solutions. Failure to adequately fund enterprises delivering reliable renewable energy to remote populations appears at odds with the main investment goal of many impact equity funds.

We believe the factors behind this funding gap can be summarised as follows:

- **Funding gap mirrors weak IPO market.** With IPO activity falling 45% during 2022 (EY, 2022), investors have been disincentivised to provide funding due to lack of exit route.
- **Valuation reset.** Resetting of valuations post recent PE exuberance has not finished. Business owners are staying private for longer hoping for higher valuations, affecting the supply/demand for late-stage funding.
- **VC contraction.** According to S&P Market Intelligence (Nov 2023), the number of VC rounds has fallen by 46% over the last 2-years. With a weak IPO market, VC is reluctant to invest. The VC industry is also struggling with capital availability.
- **Limited institutional allocations.** Institutional investors have chosen to focus on PE buy-out opportunities rather than growth PE. According to Preqin (2022), target overall PE allocations are low: 7.1% with public sector pension plans, 8.% for private.

Restricting return and impact potential

This funding gap has implications. The gap exists at the least risky stage of a company's development – it has already passed 'proof-of-concept', likely has a revenue base and possibly generates profit. Late-stage funding is arguably less risky. Having accepted higher levels of initial risk, investors may be foregoing the rewards of their patience.

Understanding these challenges, M&G Catalyst was launched. A growth equity impact strategy, it focuses on the climate, health and inclusive growth sectors. Its aims to confront the funding gap purposeful businesses face providing the late-stage funding they need.

These businesses often require more than capital – they can also be seeking a partner. The M&G Catalyst team provides both scale and a network and pool of experience helping them accelerate their growth journey. The team of 40 professionals worldwide provide insights able to identify opportunities and risk-mitigated pathways to future growth.

Addressing the problem

Impact theme	Potential investment opportunity
Climate and Environment	Climate-positive enterprises, carbon-capture technology
Health	AI-led discovery, eg, medical diagnostics and screening
Inclusive growth	Democratisation of basic needs, eg, off-grid solar

M&G Catalyst targets three impact themes:

These themes represent where Catalyst believe the largest impact investment opportunities lie. In our view it is positioned to deliver incremental value to private companies within these areas, specifically:

- **Leveraging in-house expertise.** As an integrated asset manager, a breadth of asset-class and regional expertise exists. Our private credit team can lend to Catalyst companies often more rapidly than a third-party lender. An example of collaboration would be a recent £500m co-development by M&G Real Estate team together with Catalyst in a sustainable housebuilder.
- **Flexible funding pathways.** Catalyst addresses the 'private-for-longer' trend as it is flexible, able to offer both IPO and longer-term funding pathways. Further, with a long-term internal client, capital can be accessed when needed allowing a truly innovative approach to funding.
- **Scale, reach, expertise.** Maximising returns depends on expertise and resource. As an integrated manager, we offer expertise across public and private markets and specialist research capabilities across the climate, health and social inclusion sectors.

Purposeful partnership

We believe partners exist with expertise and the investment approach required to effectively address the most pressing global challenges. According to UN Trade and Development[2], meeting UN Sustainable Development Goals (SDGs) alone requires addressing a $4 trillion annual funding gap. The mission of M&G Catalyst is to partner with, and make a positive impact for, the duration of a company's development. With aligned interests, we believe M&G Catalyst will continue to add investor value during this period of unprecedented global disruption and transition.

[1]Source: The Brainy Insights, Impact Investing Market Size by Sector, Investor, Regions, Global Industry Analysis, Share, Growth, Trends, and Forecast 2024 to 2033, January 2024.
[2]Source: UNCTAD, SDG investment is growing, but too slowly: The investment gap is now $4 trillion, up from $2.5 in 2015, SDG Investment Trends Monitor (Issue 4), September 2023.

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