PRINCIPLES FOR IMPACT MEASUREMENT AND MANAGEMENT IN IMPACT INVESTING: A GUIDE FOR FUND MANAGERS (English Translation)

GSG Japan National Advisory Board
Working Group on Impact Measurement and Management (IMM)

May 2021

ABOUT THE PRINCIPLES

These principles have been prepared specifically for institutional investors[1] in Japan who practice impact investing.

For the purposes of this document, "impact investing" refers to investment activities that are characterized by the intent to generate positive and measurable social and environmental impact[2] in parallel with financial returns. The intent of the institutional investor is considered to be the most important element that distinguishes impact investing from other forms of investing, and as a means of realizing that intent, institutional investors practice Impact Measurement & Management (IMM)[3].

In practicing these principles, IMM provides a structured approach in which institutional investors measure the impact of their investee's business and encourage improvement through engagement with the investee.

Based on the discussions in the GSG IMM Working Group, which are described below, these principles capture the basic concepts that will contribute to the realization of effective IMM. It is hoped that each institutional investor will act in accordance with these principles and take autonomous measures to increase the investee's corporate value taking into account the generated impact.

[1] "Institutional investors" is a generic term for corporate investors that invest and manage funds contributed by clients, including pension funds, life insurance companies, casualty/property insurance companies, trust banks, asset management companies, venture capital companies, and private equity funds.

[2] "Impact" refers to "social and environmental changes and outcomes (both short term and long term) that occur as a result of business or activities." (GSG Japan National Advisory Committee, *Impact Investing in Japan: Current Status and Issues - FY2020 Survey*)

[3] As defined by the Global Impact Investing Network (GIIN), IMM "includes identifying and considering the positive and negative effects one's business actions have on people and the planet, and then figuring out ways to mitigate the negative and maximize the positive in alignment with one's goals" and "is iterative by nature."

Backgrounds

- The impact investing market in Japan has moved on from its infancy period and is beginning to enter a period of growth. The impact investing balance in Japan is about 512.6 billion yen in FY2020, which is a significant increase from 317.9 billion yen in the FY2019 survey.
- Since 2018, major domestic institutional investors in Japan entered the impact investing market, while many startups that have impact generation as a core part of their business have started to raise funds through the capital market. The GSG Japan National Advisory Committee (NAB) deemed it timely to establish the Social Equity Finance Subcommittee in August 2018, in order to examine the key issues and look for solutions in using capital markets for social purposes. The Subcommittee found that one of the biggest challenges was that there were few practical examples of IMM and its approaches were fragmented and not systematic.
- Looking at the global impact investing market, IMM approaches have become increasingly sophisticated over the past 10 years, and as a result global standards for IMM are being developed at a rapid pace. This is considered a key to the future development of the "impact integrity" in the impact investing market.
- Based on this background, the GSG Japan NAB established the IMM Working Group (the WG) in 2020, in order to create a shared understanding of IMM among impact investors and to improve the quality of IMM practices. The WG, comprised of practitioners of impact investing in public and private equities from 17 companies (including observers), met six times between September 2020 and March 2021 to share and discuss the global principles, frameworks and tools of IMM, domestic and international case studies, and to identify issues and solutions for working on the IMM.
- As a result, the WG produced two outputs in Japanese, the Principles document and the "IMM Practice Guidebook," and the "Discussion Paper: Refining the Global Standard of Impact Measurement and Management -- Views from a Japanese Working Group" in English.

How these Principles should be Read

- These principles are based on the contents of the "IMM Practice Guidebook" and are the points emphasized in the IMM practice that were agreed upon and highlighted by the IMM WG members.
- These principles are intended to apply to impact investors in public and private equities, although many of the basic concepts outlined in these principles are also useful for the IMM in other asset classes.
- The WG believes that each institutional investor should devise its own way of working with the principles tailored to its own circumstances. This is because

IMM practice may vary depending on the asset class and the end investor as well as other factors. As we are witnessing a rapid development of IMM, global norms may shift as well. In light of these factors, the principles should not be viewed as detailed rules but precisely as principles with which each institutional investor should navigate its own IMM practice appropriately.

- The WG expects that domestic institutional investors in Japan who are engaged in impact investing will accept the principles of "Responsible Institutional Investor" (the so-called Japanese Stewardship Code). In addition to the principles in the Code, the principles in this document should be considered for impact investing.

Expectations behind the Principles

- These principles are based on the discussion of the WG and summarize the current global standards of IMM as well as practical knowledge from Japan and overseas. The WG deemed it appropriate to incorporate the global approach because, by doing so, 1) institutional investors will be able to communicate with various stakeholders around the world using a common language, and 2) by using the common language, fund managers will be able to raise capital and access possible investees much more broadly. At the same time, the WG felt that it was necessary to compile principles in Japanese based on the market environment and practices in Japan so that they could be widely shared with institutional investors in Japan. The WG strongly hopes that IMM norms and practices in Japan will not become isolated but rather will follow the front-runner practices in the world and produce best practices from Japan.
- The WG believes that it is important for institutional investors to practice IMM by referring to the principles and the guidebook, and to share their learning with each other. This will serve as a foundation for building an ecosystem in which risk money and necessary support are provided to businesses and entrepreneurs (including social entrepreneurs) who take on the challenge of solving social issues through business activities.

The Principles

Institutional investors practicing impact investing should follow these principles in their investments to achieve impact and to ensure its sustainable expansion.

Principle 1: Institutional investors should clearly articulate impact generation in their overall corporate strategy and formulate impact fund's investment strategy based on the overall strategy.

Principle 2: Institutional investors should design an appropriate IMM process, taking into account globally adopted approaches and methods, to ensure that investments are made in line with the impact fund's investment strategy.

Principle 3: Institutional investors should develop a deep understanding of the impact generated by the investees. This should be done by working closely to accurately understand the external and internal environment of the investee (monitoring) and by conducting constructive and purposeful dialogue with them (engagement). This will thereby contribute to the sustainable augmentation of the investee's corporate value.

Principle 4: When selling an equity stake of the investee, institutional investors should consider the sustainability of the impact generation to ensure that the impact created by the investee is not lost.

Principle 5: Institutional investors should regularly report to end investors on how they are realizing their impact intentions and contributing to the sustainable augmentation of the investee's corporate value.

Principle 1: Institutional investors should clearly articulate impact generation in their overall corporate strategy and formulate impact fund's investment strategy based on the overall strategy.

With their intent to generate positive and measurable social and environmental impact in parallel with financial returns, institutional investors facilitate the augmentation of the corporate value of the investee through consideration of the impact and promote its sustainable growth. By doing so, the institutional investors seek to increase the medium- to long-term financial and social returns for their clients and beneficiaries.

Based on this understanding, institutional investors should clearly articulate in their overall corporate strategy how to realize the intentions of impact investing as entities that manage finance in the economy, bearing in mind their own position in the investment chain from clients to investees to beneficiaries.

This strategy should incorporate fund management approaches that express value proposition to society which includes the establishment of impact themes and their integration into the strategy, the degree of compatibility between economic and social returns, and the investment decision-making process utilizing IMM.

For more details on the above, refer to the IMM Practice Guidebook.

Principle 2: Institutional investors should design an appropriate IMM process, taking into account globally adopted approaches and methods, to ensure that investments are made in line with the impact fund's investment strategy.

To realize the intentions of impact investing in line with the impact fund's investment strategy, institutional investors should design and implement an IMM process, which is a systematic method, to measure the impact of the investee's business and to encourage improvement of the business through engagement. In order to ensure a certain level of IMM quality of the impact fund, it is important to apply a consistent IMM process to all investments made by the impact fund.

The IMM process should include: identification and multi-faceted analysis of positive and negative impacts of the investee's business at the time of the investment decision; setting of key impact KPIs and targets; post-investment monitoring and engagement (Principle 3); sell/exit decisions that take into account the ongoing impact of the investee's business (Principle 4); and impact performance reporting (Principle 5).

For more details on the above, refer to the IMM Practice Guidebook.

Principle 3: Institutional investors should develop a deep understanding of the impact generated by the investees. This should be done by working closely to accurately understand the external and internal environment of the investee (monitoring) and by conducting constructive and purposeful dialogue with them (engagement). This will thereby contribute to the sustainable augmentation of the investee's corporate value.

After making an investment, institutional investors should keep track of the impact being generated by the investee's business in reference to the intended impact analyzed at the time of investment decision by monitoring the progress of the impact KPIs. At the same time, the engagement with the investee should be geared toward augmenting its corporate value from a medium- to long-term perspective.

In the monitoring and engagement process, it is important to lay out its key elements in accordance with the impact fund's investment strategy, which may include challenges surrounding the investee's progress toward the impact KPIs, issues of negative impact and the response, etc., as well as the financial status.

Although the method and depth of engagement will vary depending on the asset class and the business stage of the investee, it is important to conduct a collaborative dialogue in line with the impact fund's investment strategy. In the case of private equities, it is suggested that the investor provide hands-on support so that the IMM process becomes a common language with the investee's stakeholders.

For more details on the above, refer to the IMM Practice Guidebook.

Principle 4: When selling an equity stake of the investee, institutional investors should consider the sustainability of the impact generation to ensure that the impact created by the investee is not lost.

Institutional investors should consider when and how to sell their equity stakes in line with the intentions of the end investors. When making a decision to sell, institutional investors should give due consideration to ensuring that the impact created by the investee will be sustained.

For example, in the case of private equities, when making an exit decision, in addition to the sale price, it is important to understand the impact the investee is generating and to carefully consider how it can be further expanded.

In the case of public equities, although institutional investors may make a decision of the sale based on the financial performance of the investee, it is important to establish an investment process that makes it possible to work on a long-term investment as well as an on-going engagement with the investee that seeks to generate impact.

For more details on the above, refer to the IMM Practice Guidebook.

Principle 5: Institutional investors should regularly report to end investors on how they are realizing their impact intentions and contributing to the sustainable augmentation of the investee's corporate value.

Institutional investors should regularly report to end investors on the extent to which their impact intentions have been realized, as end investors invest in impact funds with the intention of generating impact. In doing so, a combination of quantitative and qualitative information should be reported to the end investor, such as the comparison of the performance of the impact generated with the impact KPI targets and the verification of the positive and negative impacts. By reviewing the investment activities based on this information, the lessons learned can be used to improve future impact investing and how best to conduct the IMM.

While the development of IMM is rapidly progressing in global impact investing markets, there are few examples of IMM practice in Japan. Thus, it is important for institutional investors in Japan to share the lessons learned with both the global market and the Japanese investment industry in order to repeat the learning and improve the IMM process by utilizing familiar business cycle approaches such as the PDCA (Plan-Do-Check-Act).

For more details on the above, refer to the IMM Practice Guidebook.

［end］