FRANKLIN TEMPLETON

Alcentra

INSIGHTS INTO
Achieving Impact In Direct Lending

Introduction

As the world faces ever-growing social and environmental challenges - from the IPCC's gloomy temperature rise predictions, to all seventeen UN Sustainability Development Goals ("UN SDGs") falling short of achieving their 2030 targets - investors are increasing their allocation to impact investing and are building sound impact frameworks to measure and manage the positive real-world changes they generate.

Impact investing promotes both financially sound and environmentally & socially positive outcomes. With most market participants requiring solid financial returns that meet or exceed market expectations, financial performance considerations have become key elements underlying the momentum that the strategy is gaining.

The **landscape of impact investing is evolving**. While private equity and venture capital have traditionally dominated (with these two representing over 60% of impact funds launched in the past decade), new strategies like **direct lending are gaining traction**. This shift is largely due to **asset owners seeking to balance their impact goals with the need for stable, risk-adjusted returns.**

As a result of the increasing dual demand for impact products with stable financial returns, **direct lending investors and managers are increasingly interested in seizing this opportunity** and designing impact investing strategies by leveraging the close relationships they build with businesses, and the influence they have, throughout the structuring phase of transactions.

Impact direct lending strategies provides investors with several advantages compared to the wider private debt asset class (which include real estate & infrastructure). This includes closer relationships & access to management, a broader investible universe, and an ability to structure bespoke deal terms and impact objectives. Furthermore, as opposed to dedicated impact funds, which may suffer from concentration risks, **generalist direct lending funds with impact-like features can meet LPs' financial & impact objectives without additional concentration risk**.

At Alcentra, our European Direct Lending team supports **mid-market businesses achieve positive impact** by targeting sectors that provide solutions to environmental and social issues as well as scaling up the use of Sustainability-Linked Loans (SLLs) to tie borrowers' positive outcomes to financial rewards.

In this whitepaper we provide **insights into some of the key characteristics and the evolution of impact investing**, with a deep dive into why we think direct lending to be a particularly well-suited investment strategy to achieve impact and financial goals. Additionally, we will **showcase our approach to impact direct lending** as an additional overlay to our standard ESG integration process, aimed at maximising the positive change generated by our investments.

1 Impact Investing Explained

Impact Investing Explained

What is Impact Investing?

As defined by the Global Impact Investment Network (GIIN), impact investments are "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return".

Investors can **achieve impact by channelling capital to borrowers** that pursue positive outcomes, **either as result of their core business activities or through their operations**. Investors are required to demonstrate: (i) impact is being considered throughout the investment process; (ii) outcomes are measured with a sound methodology; and (iii) the investment has materially contributed to the achievement of a real-world impact.

Figure 1: Financial performance relative to expectations

Impact Investing Gaining Momentum

With the increasing number of impact investments delivering financial returns (Figure 1), the market has started to see three core trends that signal growth and standardisation:

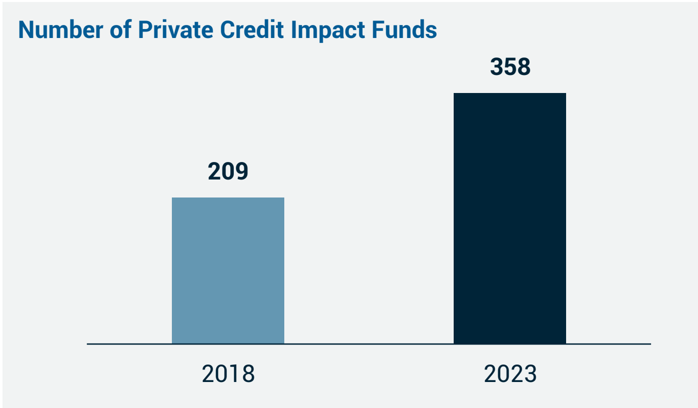
Alignment to Frameworks

Investors are showcasing **greater alignment to industry standards** to allow comparability between funds. To mention a few, these include the **GIIN's IRIS+ metrics,** the **Five Dimensions of Impact,** Article 8 and 9 of the **EU SFDR**, and the SDI Taxonomy to assess investment alignment to **the UN SGDs.**

Diversification into New Asset Classes

New strategies such as direct lending are entering the space, increasing the appetite for those asset owners that wish to **build an impact investing strategy whilst seeking attractive risk-adjusted returns** (Figure 2 & 3).

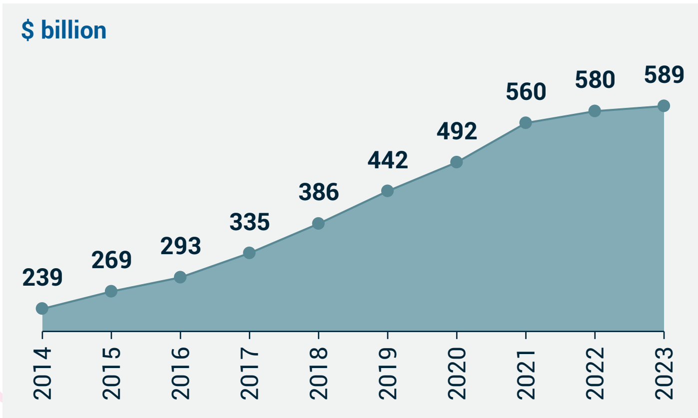
Figure 2: Cumulative number of impact private credit funds (direct lending, microfinance, mezzanine debt)



Growing Demand

The market has seen a growing demand both in terms of number of impact products and better impact measurement and management capabilities, to drive positive change while efficiently managing investment risk.

Figure 3: Cumulative impact capital raised per year



Source: GIIN. 2023 GIINsight: Impact Investing Allocations, Activity & Performance
Source: Phenix Capital Impact Report June 2023

Making the Most of Impact Tools and Frameworks

What is an Impact Framework?

Impact frameworks and tools enable investors to link their intention of achieving positive impact with real-world outcomes produced by their investment decisions. Among the **many frameworks available in the market, there are a few that stand out** because of their significant market-level adoption and **validation by impact investing standard setters such as the GIIN's IRIS+.**

UN Sustainability Development Goals

One of the most common and widely adopted frameworks to aid investors in identifying and clearly communicating their impact objectives.

17 SDGs highlight the connections between the environmental, social & economic aspects of sustainable development.

Theory of Change

A logic chain that offers a description and illustration of how impact is ultimately achieved, linking the capital provided (input) to the achievements of the goals set (outcomes), passing through the products and services of the investee companies selected (activities & outputs).

Five Dimensions of Impact

Enables investors to ensure a specific investment will fulfil their aims by answering questions around what outcome is the enterprise contributing to and how much, who is benefitting from it, the contribution to the outcome of the capital provided, and the risks of not achieving the impact expected.

GIIN IRIS+ Impact KPIs

To effectively manage impact, KPIs should measure outcomes. Where possible, enterprises should start with existing standards when sourcing KPIs, to enable greater comparability and ensure that well-evidenced metrics are used as much as possible.

Impact frameworks should be leveraged throughout the investment process as they **ensure rigour, alignment, and represent a shared language across stakeholders**.

Impact Frameworks Over the Years

Before the widespread market adoption of industry frameworks, it was up to managers and LPs to define what positive impact meant in the context of their investments, without having clear guidance from standard setting organisations.

Despite many of these frameworks having been available in the market for some time, it is only recently that investors have increased their uptake – the latest GIIN's survey on "impact measurement and management" concluding that **most impact investors use at least two impact frameworks** of their choice to design their impact investing approaches and two **tools to measure and manage the impact outcomes achieved.**

This shows a **higher level of standardisation in the market**, whilst leaving considerable freedom to investors to tailor their own impact strategy to best fit into and align with their wider investment beliefs.

Figure 4: Investors Using UN SDGs

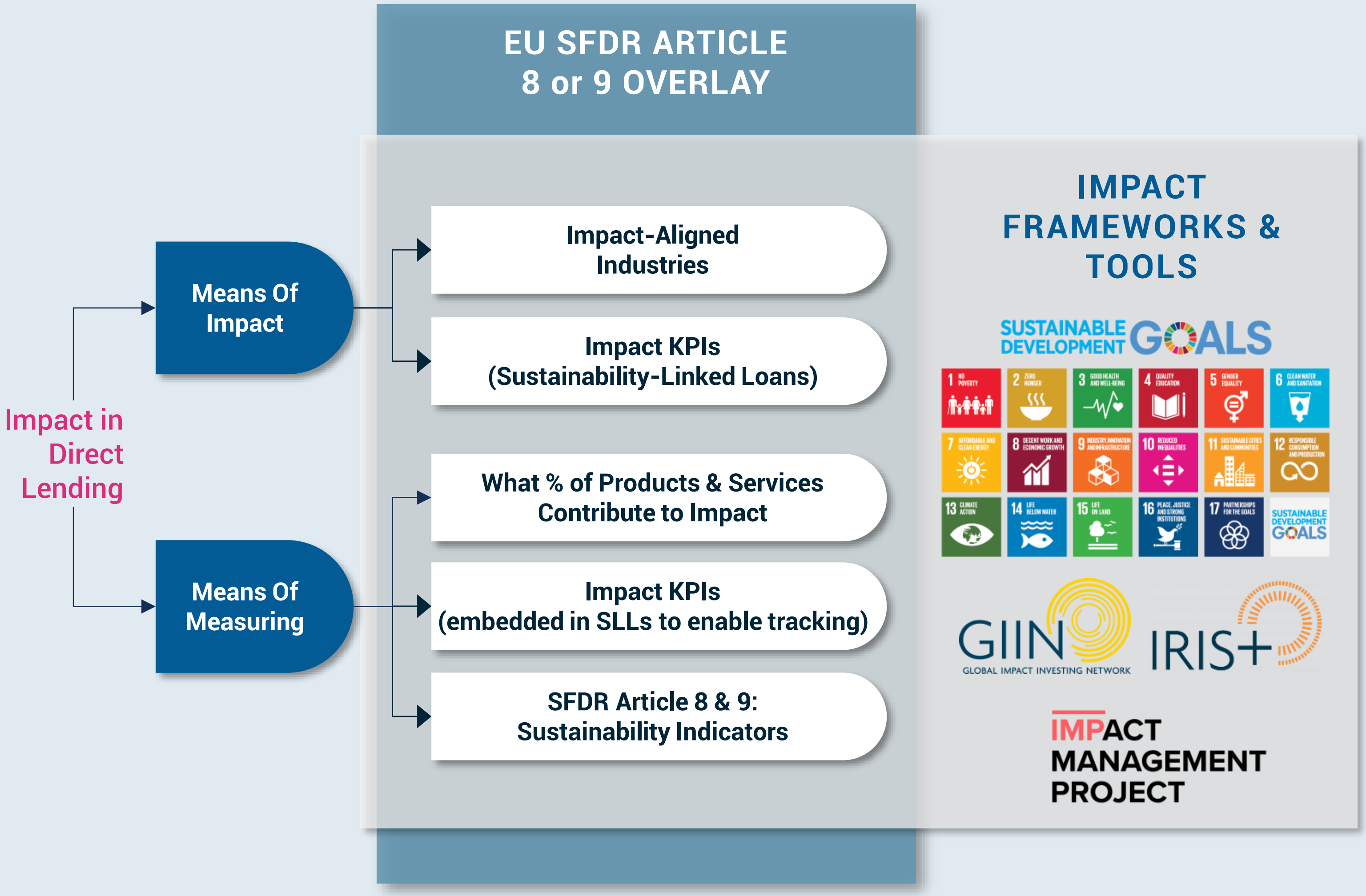
Source: GIINSight Survey 2023 "Impact Measurement & Management Practice"

2 Why are Direct Lenders Well Placed to Achieve Impact

Generating Positive Outcomes via Direct Lending

How to Achieve Impact in Direct Lending?

Impact direct lending strategies have the advantage of generating positive outcomes not only by selecting portfolio companies in industries that naturally generate impact **(impact-aligned industries),** but they can also leverage debt instruments and features specific to their investment strategy, such as covenants and Sustainability-Linked Loans (SLLs), to tie borrowers' achievement of positive outcomes to material financial incentives **(impact KPIs).** The latter can align with other regulatory frameworks such as EU SDFR Article 8 & 9.



What is considered as an Impact Outcome?

Impact investing takes investors **beyond ESG** (environmental, social and governance). The latter – becoming an increasingly standard part of the investment process – assesses "how" an enterprise operates and aims at reducing the harms of its operations and conduct.

Impact investing goes beyond this and refers to "what" positive outcome is the borrower going to achieve as a result of its products and services and/or its direct operations.

The two are different but complementary parts of a company's business.

It is key for investors and managers to be aware of these differences when sourcing assets and setting KPIs to guarantee the implementation of a coherent impact strategy and succeed in their goal of achieving positive change.

Why Lenders are Well Placed to Achieve Impact

Why Invest in Impact Direct Lending?

Impact direct lending strategies provides investors with several advantages compared to the wider private debt asset class (which include real estate & infrastructure), due to closer relationships & access to management, broader investible universe, and ability to structure bespoke deal terms to help achieve:

Impact Objectives

- Via core activities or via impact KPIs
- Increased engagement potential

Financial Objectives

- Attractive risk adjusted returns
- Loan covenants for downside protection and high recovery rates

Diversification

- Low concentration risk
- Lower correlation with public capital markets and lower return volatility in turbulent markets

Impact Measurement

- Closer relationship enables private-side direct lenders to agree on the most relevant impact metrics, data, and KPIs

As opposed to dedicated impact funds, which may suffer from concentration risks, **generalist direct lending funds with impact-like features** can meet LPs' financial & impact objectives without additional risk.

Impact Measurement and Management in Direct Lending

One of the most challenging, yet integral, steps of impact investing is the **monitoring and measurement of the progress towards impact goals**. This is particularly true in private markets, where the lack of data and standardisation around impact reporting makes it harder to assess risks, compare different investments, and quantify positive outcomes. However, thanks to the adoption of upcoming taxonomies and the privileged position direct lending investors have in influencing investee companies towards setting impact targets, these challenges are being increasingly met (Figure 5).

Additionally, in order to succeed in their intent to quantify the positive impact generated, the impact KPIs selected and agreed upon should:

- Be a measure of outcomes rather than activities;
- Be sourced starting from existing standards (e.g. IRIS+, UN SDGs) to ensure robustness and comparability;
- Get selected through a systematic approach that ensures alignment with the borrowers and investment mandates' goals (Figure 6)

Figure 5: Levels at which quantitative impact targets are set

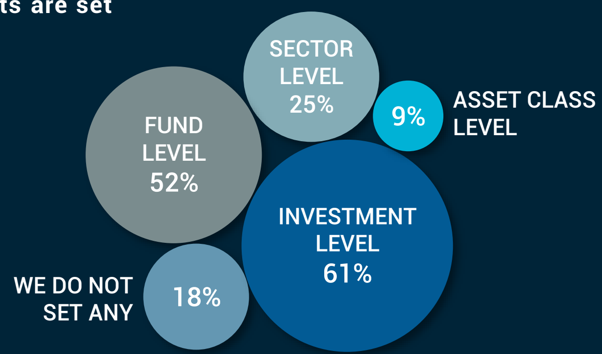
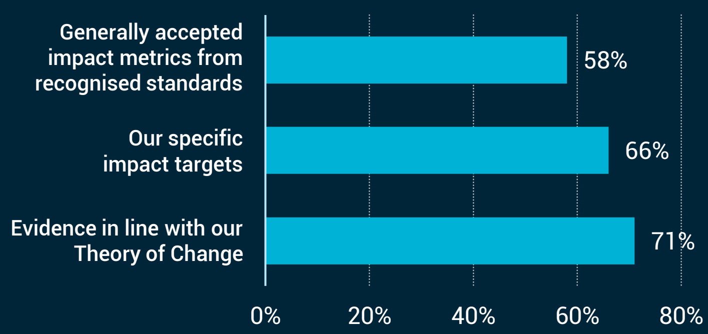


Figure 6: Top three factors influencing the selection of KPIs



Source: GIIN. 2023 GIINsight: Impact Measurement & Management

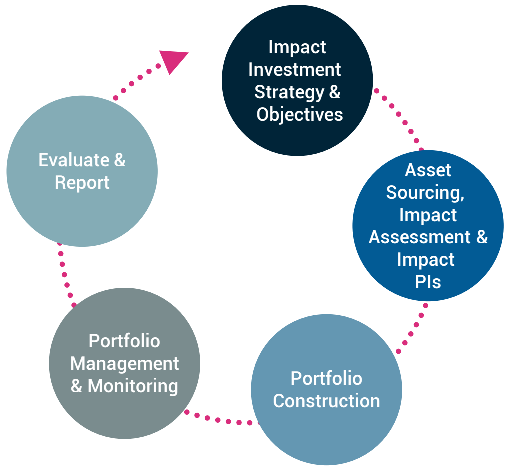
Stakeholders' Dynamics in Impact Direct Lending

Impact Direct Lending Enables Stakeholder Alignment

The main stakeholders involved in an impact direct lending investment model are the LPs, the asset managers, the borrowers, and the end stakeholders. Despite being challenging, **clarity on and alignment of impact intents** of these four parties is crucial to:

- Guide LPs in the selection of managers, and managers in portfolio construction;
- Ensure managers and borrowers' accountability to meet expectations on the intended impact;
- Enable effective reporting on impact objectives being met;
- Agree on an impact time horizon and set expectations on what is considered a success; and
- Have a shared view on how to navigate potential market volatility whilst protecting impact integrity

Figure 7: Illustrative Impact Investment Model



As already mentioned, by providing clarity on final impact goals and outlining the logic chain linking actions to outcomes, impact frameworks represent a powerful tool not only to design an effective impact strategy, but also to provide a common language to the different stakeholders and overcome the challenges outlined above. See below a summary of key actions and expectations for an impact model to work efficiently:

Identifying Impact Goals by Stakeholder

LPs

Set Impact Objectives	Assess and Select Credit Managers
• To inform the selection of most aligned managers • To report on impact outcomes and progress towards their goals	• Managers' impact strategy assessment and position along the spectrum from impact-first to finance-first • Borrowers' real-world impact assessment

Direct Lending Managers

	Intention	Process	Measurement	Contribution
LPs' Expectations	A well-defined impact objective to assess alignment with own goals	Impact integrated throughout investment process to ensure consistency	Clarity on outcomes being measured and how, to ensure accountability	Proof of catalytic role of capital provided to the outcomes achieved
Required Managers' Actions	Use frameworks to set and outline impact goals in a common language	Apply as much rigour to impact process as financial process and embed impact into BAU	Leverage outcome KPIs and targets to systematically quantify real-world changes	Design Theory-of-Change to outline logic chain between capital and outcomes

Borrowers

Intention	Measurement	Additionality
Clearly state the aimed outcomes to attract capital	Involve end stakeholders to comply with the most robust impact measurement	Leverage flexible deal structures to efficiently finance impact

End Stakeholders Benefitted

3 Opportunities and Challenges for Direct Lending Managers

Challenges and Opportunities for Direct Lending Managers

How to Navigate Challenges & Opportunities in an Impact Direct Lending Strategy

The growing demand for impact investment products and their suitability to deliver impact is signalling wider growth. But both investors and managers are faced with a steep learning curve to ensure success and recognition for their efforts.

Impact investing presents several challenges, but we believe the **direct lending asset class has the right features to tackle them**, and eventually turn them into valuable opportunities.

	Wider Market Challenges	Direct Lending Opportunities	Action Points
Defining Impact	• No wide consensus on impact definition • Going beyond ESG considerations • Risk of confusing impact with impact-like fund features	• Deep knowledge of businesses to uncover impact opportunities • Close relationships with borrowers enables timely identification of impact opportunities	• Set clear impact goals and theory of change ahead of formulating impact strategy to offset risks of "impact washing" and increase efficiencies
Concentration Risk and Allocation of Assets	• Narrow universe of companies can lead to concentration risks for pure-play impact funds • Risk of investors chasing the same deals	• Generalist direct lending funds benefit from a broad portfolio, reducing concentration risk yet still having impact-like features • Helps avoid chasing deals with poor terms	• Leverage existing relationships to explore impact opportunities offsetting risks of overcrowded deals • Spot positive impact in non-traditional impact industries
Integrating Impact	• Prove additionality of capital invested towards impact outcomes • Clearly outline impact considerations without unanimous guidance and/or standards to comply with	• Flexibility to build bespoke impact strategies • Reputational benefit for LPs & managers as additionality of impact goals easier to identify vs broadly syndicated transactions	• Leverage features and tools specific to direct lending • Leverage frameworks to set up impact logic chain • Design systematic assessment/monitoring process
Creating Value: Financial & Impact	• Finding the balance between financial and impact expectations • Overcome the stereotype of pursuing impact goals resulting in a financial performance trade-off	• Attractive risk-adjusted returns • Good financial performance track record for vast majority of impact investors	• Take advantage of loan covenants for downside protection • Diversify portfolio to derisk • Add impact strategy as overlay framework to BAU processes to protect value
Evolving Frameworks	• Dynamic landscape with everchanging new frameworks and standards being developed and updated	• Flexibility to implement market best practice to ensure efficiency in generating valuable change • Increased comparability as an opportunity to stand out	• Stay up to date on new frameworks being launched and market standards • Be creative to leverage the different frameworks in a bespoke way to serve own investment mandate

4 Alcentra's Approach to Impact Direct Lending

Alcentra's Approach to Impact Direct Lending

Our Impact Framework

Challenging the consensus view that impact investments are only possible via equity or venture capital investments, at Alcentra we see our European Direct Lending strategy as part of the solution as an innovative and effective response to addressing real-world issues.

In addition to applying our rigorous yet standard ESG integration process throughout the investment lifecycle, the investment opportunities going through the lens of our impact framework are subject to an extra layer of analysis.

Building on top of the BAU investment process is a way to ensure protection of value creation and the generation of financial returns as well as positive impact.

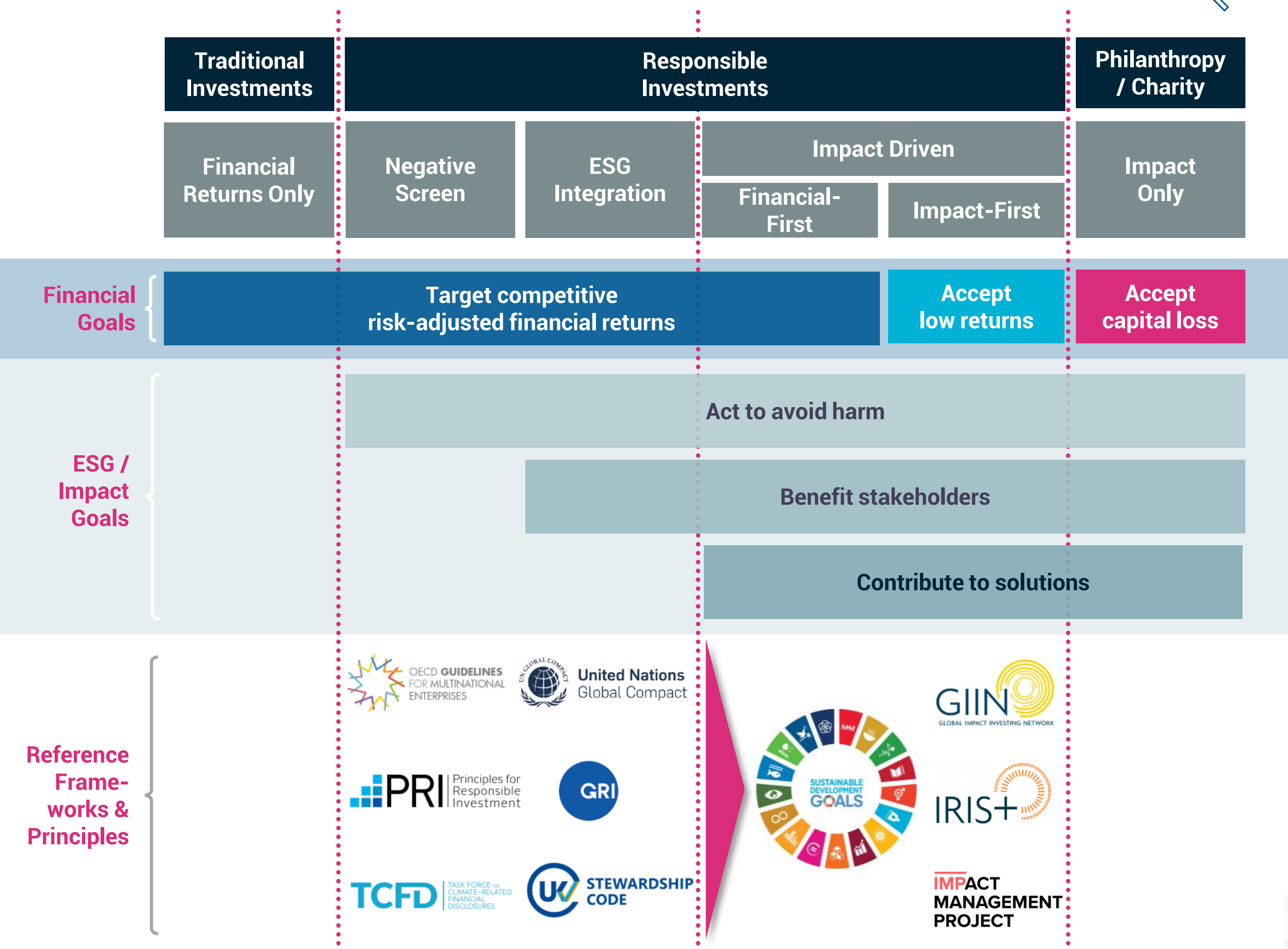
The impact-focused objectives of the strategy offer a combination of strong financial returns and positive and measurable social and environmental outcomes, by **supporting mid-market European companies** to achieve real-world impact where possible. We do so through:

i. **Direct investment in businesses delivering positive change through their products or services**; and/or

ii. **Embedding impact KPIs in the debt instrument** (via Sustainability-Linked Loans to borrowers)

The aim of both routes is to **align to the UN SDGs** (and/or other recognised impact frameworks) leveraging the **Five Dimensions of Impact framework**.

ESG integration + Overlay of Impact Considerations



Source: Phenix Capital; Alcentra

Setting Impact Goals for Our Direct Lending Strategy

Our Strategy's Alignment with the UN SDGs Framework via SFDR Article 8 Commitments

Our European Direct Lending strategy has historically benefitted from SFDR Article 8 requirements. The relevant fund aims to promote **ambitious environmental & social characteristics** for a minimum 70% of invested capital, **which enables us to set clear impact objectives** in alignment with both our investor mandate and the goals promoted by the UN SDGs.

Our latest fund aims to go one step further with even more ambitions impact objectives, namely:

i. **Solutions** to **limit the impact of climate change and/or circular economy practices**;

ii. **Engagement and positive outcomes across human rights, workplace equality, workplace diversity, and social & financial inclusion**

SFDR Article 8

Impact Goal	Sustainability Indicators	UN SDG Mapping
"Engagement with, and increased action on climate change and / or circular economy practices"	"The percentage of borrowers with KPIs related to climate change and / or circular economy practices"	13 Climate Action; 12 Responsible Consumption and Production; 11 Sustainable Cities and Communities; 7 Affordable and Clean Energy
	"The percentage of capital invested with borrowers that have set a climate target / solutions"	
"Engagement with, and increased action on human rights, workplace equality, and workplace diversity"	"The percentage of borrowers with an KPIs related to human rights, workplace equality and diversity"	8 Decent Work and Economic Growth; 3 Good Health and Well-Being; 5 Gender Equality; 10 Reduced Inequalities
	"The percentage of capital invested with borrowers that have in place a diversity and equal opportunity policy"	

The Sustainable Development Investments (SDIs) Taxonomy

The SDIs provides the market standard foundation and criteria to map investments to the SDGs with the aim of helping investments to deliver on the sustainable goals and provide evidence for it. As showcased below, the taxonomy identifies two ways of achieving the SDGs depending on the nature of each. This is aligned with Alcentra's twofold approach to produce impact through impact-related industries and SLLs.

P Contribution through products and services (solutions)

O Contributions through operations and conduct

Case Study - Impact-aligned Industry

Overview

Company X is a TICC (Testing, Inspection, Certification, Compliance) services provider focused on a wide range of analytical, logistical and specialist services across segments in Food, Environment and Life Sciences.

The company upholds sustainable practices, compliance with environmental regulations and enhancement of the safety and quality of consumer products – a direct benefit of its products & services.

These features have stood out throughout the different steps of our impact assessment, demonstrating alignment of the business to the objectives of our investment strategy and theory of change, as outlined below.

Impact Framework

Impact Aligned Industry

- Company X offer a range of services including laboratory analysis, data management, and specialized logistical support for clinical trials;
- It also provides consulting services for private companies and public institutions in research, product development, market development, and consumer protection;
- The company operates in an attractive and sizeable market benefitting from growing volumes and attractive verticals driven by increased outsourcing trends, stricter regulatory requirements and public sector environmental targets (ensuring sound financial risk profile)

Impact Features

- Company X's food analysis enhances product quality and guarantees contaminant-free products reach the market, ensuring availability of **safe food**;
- The company's analytical services also contribute to the pharmaceutical and medical devices sectors. It supports drug manufacturers in producing **safe** and **effective drugs** and **vaccines**
- It ensures **clean drinking water** by analysing contaminants, conducting environmental tests, and supporting regular testing for legionella in drinking water
- Its expertise enhances recycling processes and eco-friendly **waste management**, recovering valuable resources and reducing waste

UN SDG Alignment

Case Study - Impact through SLL KPIs

Overview

Company Y is a digital ad management platform which allows its clients to control, analyse and monetize their advertising channels and formats (display, video, native) on all type of devices (desktop, mobile web & apps, connected TV).

The business offering includes ad server services, a sell-side platform "SSP" used by publishers and a demand side platform "DSP" used by media organizations i.e. the ad buyers. Company Y ranks among Top 5 SSP players in Western Europe and among Top 10 SSP players worldwide.

Company Y works alongside advertisers, publishers, broadcasters, and rights owners. The business service nature of the company limits the broader impact potential. Nevertheless, the company has embedded KPIs, with the social and governance ones resulting in a wider impact to its employees and customers than the KPI targets alone.

Impact Framework

KPIs	Targets	Margin Ratchets	Target Impact Outcomes	UN SDGs Alignment
Scope 1-3 emission with Climate Transition Plan (GHG protocol)	Complete emissions mapping and set reduction targets	5bps	1. Assess **carbon footprint & design transition plan** 2. Build a **sustainable solution** for customers 3. Comply with **CSRD**	13 CLIMATE ACTION
Employees' engagement score	Maintain top 3 ranking in France & world	5bps	1. Promote **DE&I** 2. Ensure **Health & wellbeing** of employees 3. Encourage **learning & professional training**	10 REDUCED INEQUALITIES
Implementation of four key governance policies, procedures & processes	Anti-money laundering; Cyber Security; Human Rights & Modern Slavery; Health & Safety	5bps	1. Advocate for **data privacy** 2. Fight for **equality across supply chain** 3. Implement **governance policies & frameworks**	8 DECENT WORK AND ECONOMIC GROWTH

5 Appendix

Definitions Glossary

1. **Additionality:** The additional impact achieved by the presence of an impact investor
2. **Blended Finance:** Blended finance refers to a combination of financing to meet the needs of for-purpose organisations - for example, part debt and part grants
3. **Circular Economy:** An alternative to a traditional line-economy (make, use, dispose), in which resources are kept in use for as long as possible, extracting maximum value from them whilst in use, then recovering and regenerating products and materials at the end of each service life
4. **ESG:** Environmental, social, and governance (ESG) criteria are a set of standards for a company's operations that socially conscious investors use to screen potential investments
5. **ESG Integration:** The systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions
6. **Exclusions** – Exclusions prohibit certain investments from a firm, fund or portfolio
7. **GIIN**: Global Impact Investing Network
8. **Impact Centred:** Refers to business models and/or activities where when revenue is generated, impact is also generated for people and/or the planet
9. **Impact Investing:** Investments made with the intention to generate a positive, measurable social and environmental impact alongside a financial return. Examples include social bond funds, private impact investing and Sustainable Development Goals (SDG) impact funds
10. **Impact Measurement:** A way to assess the value an organisation or program is delivering to the people or places it serves.
11. **Impact via Operations:** Refers to business models and/or activities where impact is created in their operations, for example providing employment opportunities to those people who are furthest from the labour market or supporting environmental impact through supply chain
12. **Outcomes:** The sustained, long term observable changes in behaviours, level of functioning, status, skills, knowledge or attitudes that result from activities
13. **IRIS+:** A set of tools and metrics owned by the GIIN that helps investors translating impact intentions into measurable results
14. **Positive Screening:** Actively seeking out companies that make a positive contribution to the environment or society or which stand to benefit from long-term sustainability trends
15. **SDI**: Sustainable Development Investments Asset Owner Platform
16. **SFDR:** The EU's Sustainable Finance Disclosures Regulation requires managers to assess and disclose how sustainability risks are considered in their investment processes
17. **Sustainability-Linked Loans / Bonds:** Types of loan or bond instruments which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives
18. **Taxonomy**: A practice and science concerned with classification or categorization
19. **UN Social Development Goals (SDGs):** 17 high-level goals forming the blueprint to achieve a better and more sustainable future for all

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