GIIN
GLOBAL IMPACT INVESTING NETWORK

GIIN INITIATIVE FOR INSTITUTIONAL IMPACT INVESTMENT
CASE STUDY: *Prudential Financial, 2018*

The GIIN Initiative for Institutional Impact Investment supports institutional asset owners seeking to enter or deepen their engagement with the impact investing market, by providing educational resources, performance research, and a community of practice. The Initiative is made possible by the generous support of JPMorgan Chase & Co., a founding member and longtime partner to the GIIN.

This series of case studies represents one type of educational resource offered to the growing institutional community. Each case study profiles one institutional asset owner that has started to make impact investments, providing a snapshot of what they did to make it work thus far. The case study series provides a useful tool for institutional investors seeking to understand how to make the case for, and then establish, an impact investment strategy, based on examples from peers. If you are interested in contributing to this resource, please contact Josh Scott.

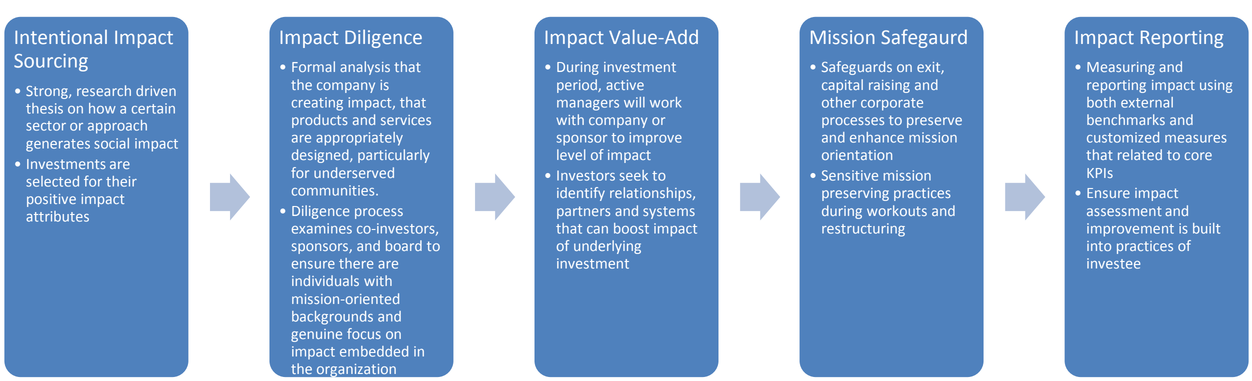
Prudential Financial, with operations in the U.S., Asia, Europe, and Latin America, provides its customers with a variety of products and services, including life insurance, annuities, retirement-related services, mutual funds, and investment management. For this case study, we interviewed Ommeed Sathe, Vice President, Impact Investments, who is a member of the advisory board for the GIIN Initiative for Institutional Impact Investment and a GIIN Investors' Council Member.

How do you define impact?

When Ommeed Sathe, Vice President, Impact Investments, at Prudential describes impact investing, he starts by distinguishing it from the wider universe of responsible investment strategies, particularly Environmental, Social and Governance (ESG). ESG is viewed as a sophisticated filtering mechanism for thinking about risk factors that can negatively impact economic performance and at the margin, might enhance economic performance. What differentiates ESG from impact investing at Prudential is not the amount of impact per dollar, as some might expect, but rather the process of selecting and managing these investments. "ESG is like choosing the best dish on a restaurant menu and impact investing is like going into the kitchen and cooking a great dish. If you do both well, you will come up with a great investment that tastes good, yet it's a process distinction." At Prudential, the ESG process involves filtering and passivity, and makes little attempt to be additional by improving the ESG practices, scores, or behaviors of companies. Impact investing, on the other hand, is fundamentally about investing where the market would not automatically go.

Defining impact investing in this way might suggest a narrow universe of investment opportunities, but this has not been the case for Prudential. "We have abundant data that vanilla capital markets will chronically underinvest in complicated things like diverse and underserved markets, women, and minority entrepreneurs - sectors with complex regulatory overlays and transactions that are unduly complicated, especially when they are small." But for the impact, Prudential would not look at these complex and hard to exit opportunities; the impact allows the team to put up with the additional 'brain damage' in those sectors. "What is being solved for is not that the investments made are any less profitable. They are actually quite profitable, and they should be. Instead, we are solving for the fact that investments are more complicated, smaller, illiquid at times, and unfamiliar in ways that are not palatable to conventional capital markets."

Ultimately, Prudential believes managing for impact is the core of what defines the team as impact investors and drives financial return. This is an active process requiring a team of dedicated professionals working through a well-defined method to add value beyond invested principal. They capture key stages of the process in the diagram below, but the process itself is highly iterative and not as linear or sequential as the diagram may suggest.



What have you done to start making impact investments?

Prudential first set up a dedicated team to do community investing – a subset of the impact investing universe – in 1976, as part of a comprehensive corporate response to community need in Newark that included creation of The Prudential Foundation, an independent non-profit.

In the last 40 years, Prudential has built an in-house team with a standalone portfolio that reports directly to senior leadership while leveraging the firm's existing investment management capacity. "Having a standalone team allows us to gain traction, ensure accountability, get deals done, and develop a certain level of predictability and expertise. But it's also important to have integration with asset class managers because many impact investing opportunities, if properly understood, fit in with existing mandates." To this end, Prudential's impact investing team partners with its mainstream asset manager colleagues to migrate certain scalable and predicable impact investment theses towards more traditional strategies.

This culminated in Prudential creating its first impact strategy that is investable by third-party clients: the PGIM Real Estate Impact Value Partners fund (PREIVP). PREIVP is focused on affordable housing and transformative development in both core and secondary U.S. markets anticipating population and economic growth. Impact Investments collaborated with PGIM Real Estate to develop both the business and impact strategy for PREIVP, taking advantage of the subject matter expertise of both areas within the firm. PGIM Real Estate is the real estate investment business of PGIM, Inc., the global investment management business of Prudential Financial, Inc. with $69.2 billion in assets under management. The strategy will meet the needs of clients who are looking for specific types of sectoral impact, as well as clients who are more agnostic, but want investments that are impact aligned combined with strong reporting and impact measurement. The goal of PREIVP is to select assets in which impact aligns naturally with the business plan, so that returns are enhanced by paying attention to how the investments are improving the lives of their users. Affordable housing, for example, has strong current income with reduced volatility and low default rates relative to other commercial real estate asset classes. Transformative development integrates mixed-use retail and residential projects in urban centers with access to transportation and workforce housing, opening new markets to growth and connecting underinvested communities with new opportunities.

Currently, Prudential's impact investing allocation is entirely funded from the Prudential General Account. Within the core impact investing portfolio, 20% of assets are in R&D or venture type investments, which lack a track record, but contribute to a 'learning dividend' by giving the team unique insights into emerging investment areas ahead of their peers. Risks on the initial investments are repaid as sectors scale and grow. For example, Prudential's first charter school loan was made 20 years ago before anyone knew how charters were going to work. The loan gave the firm an early advantage for understanding the marketplace and they now routinely do $30 million transactions with the best in breed operators.

The assets in the impact investment portfolio have a total market value of $784 million and are comprised of approximately 60% in private credits and 40% in different alternatives. The debt portfolio is largely private placements of direct debt with charter schools, real estate developers, and nonprofit loan funds, all with a long history of financial performance and social impact. The alternatives portfolio is concentrated among direct real estate, often in Newark, private equity managers in emerging markets and domestic investments focused on affordable housing, education, and financial inclusion. Financial performance has been quite good across asset classes as the majority of these impact strategies outperform their respective mainstream financial performance benchmarks.

Why did your approach work?

Having senior executive-level buy-in for impact investing has been critical, particularly given the flexibility needed to reach a range of complex and non-traditional areas. For Prudential's senior leadership, investing to improve Newark and the surrounding community was deemed one of four priorities as part of their legacy at the firm. As a direct reflection of this, the impact investment unit reports to subcommittees of the board of directors and top senior management. "On the scale of Prudential, this work is relatively modest, so getting the right senior-level buy-in allows for the risk-taking, innovation, and learning that enables us to do the work well, while ensuring that impact investing is not buried in someone else's P&L."

In terms of governance and reporting, the firm takes a portfolio view versus a transaction level view. Individual transactions are authorized through a small number of full-time employees, rather than a large investment committee, but there is a much wider group of stakeholders that reviews overall portfolio strategy and aggregate risk limits. This properly shifts the focus away from any one individual deal to the diversity of assets in the portfolio and its overall performance.

Finally, an important differentiator has been having the right team in place. "Whether you are trying to increase the impact, report on the impact, or simply trying to understand the impact – all of those actions require a team. Having people who can follow these investments, engage with management, keep up-to-date on reporting, and manage relationships is really important."

What advice do you have for institutional investors interested in impact investing?

The most important thing is to start and iterate, rather than agonize over whether to do this at all. Start with a small investment in a few things and then wait to see what happens. "The first step is the hardest step. For big institutions, it's as hard to procure a stapler as it is to procure an office building. Everything culturally is designed to not try something. But instead, consider the worst that can happen and start from there."

Sathe believes that impact investment is, in many ways, more of a natural fit for institutional investors than for corporates or banks. For one, a huge subset of Prudential's social theses are theses, which have long-dated payoffs and very much match the duration and risk profile of institutional investors. Second, most institutional investors either by size or source of capital have some greater civic responsibility – the funds ultimately came from people who are vested in society doing better, which creates a natural alignment in terms of who this money is being managed for. Finally, institutional investors are structurally well-positioned to make impact investments work at scale – given their durations, their proven capacities to invest and manage money, and their balance sheets, which can absorb significant volatility.