

Contracts with (Social) Benefits: The Implementation of Impact Investing

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Question

- ▶ Impact investing: PE/VC investing with both financial *and* social benefit goals
 - ▶ Rapidly growing sector, with at least \$228 billion AUM and \$36 billion in deals in 2019
- ▶ Dual objective complicates contracting problem
 - ▶ Investors need to incentivize & discipline fund managers to achieve both goals
 - ▶ Likewise fund managers contract with portfolio companies for financial and impact performance
- ▶ How do contracts reflect dual goals of social benefit and financial returns?
 - ▶ First empirical analysis of impact investing fund contracts
 - ▶ Predictions from contract theory for structure and context

Empirical Approach

- ▶ Hand collect 214 legal documents from impact investing funds
 - ▶ 118 contracts with limited partners (LPs): limited partner agreements, private placement memoranda, side letters
 - ▶ 96 contracts with portfolio companies (PCs): term sheets, investor agreements
- ▶ Two types of impact funds
 - ▶ Market Rate Seeking (MRS): targeting competitive, market rate returns
 - ▶ Non-MRS (NMRS): targeting below market returns
- ▶ Three-way comparison
 - ▶ Contracting patterns of impact v. non-impact funds, building on existing literature
 - ▶ Contracting patterns of MRS v. NMRS impact funds, within our sample
- ▶ Examine multiple dimensions of all contracts
 - ▶ Individual provisions (e.g. compensation tied to impact, board seats)
 - ▶ Aggregate ‘scores’ for different dimensions (e.g., impact, governance)

Findings

1. Few impact funds tie compensation to impact

- ▶ Most retain financial incentive structure, with some innovative exceptions
- ▶ Contrary to expectations from multi-tasking models, where rewarding one activity may distort effort allocation

2. Funds do contract on impact directly

- ▶ Mix of flexible and rigid terms, with more flexibility in NMRS funds (consistent with theory)
- ▶ More contracting on impact at investor-fund level flows through to more contracting at fund-PC level

3. Impact funds have more ‘participatory’ governance, especially MRS funds

- ▶ Consistent with “braiding theory”, where formal governance supports flexibility when hard to contract

4. MRS funds tend to contract more than NMRS funds on both goals

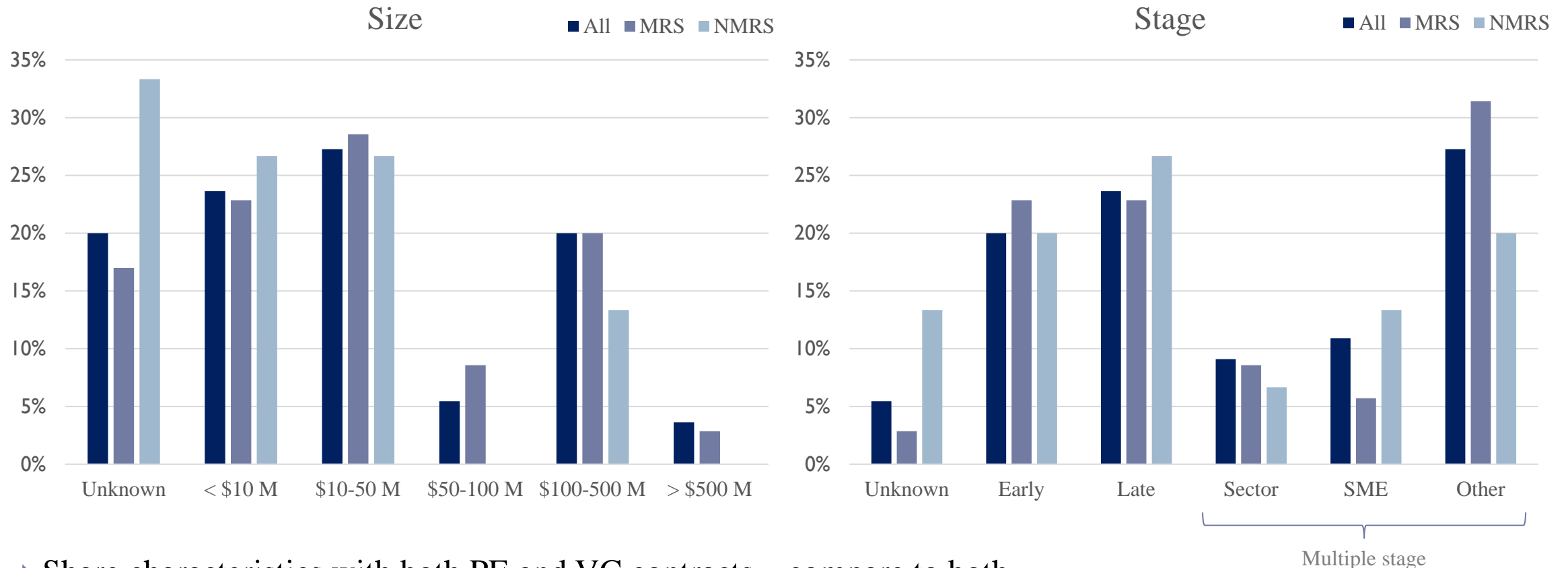
- ▶ Sketch a model where this results from hidden differences between agents’ utilities

Literature

- ▶ **Private equity and venture capital**
 - ▶ Kaplan & Schoar (2005), Phalippou & Gottschalg (2009), Kaplan & Stromberg (2009), Cummings & Walz (2010), Da Rin, Hellmann & Puri (2013), Da Rin & Phalippou (2017), and more
- ▶ **PE and VC contracts**
 - ▶ PE: Gompers, Kaplan & Mukharlyamov (2016), Metrick & Yasuda (2010)
 - ▶ VC: Gompers & Lerner (1996, 1999), Kaplan & Stromberg (2003), Gompers, Gornall, Kaplan & Strebulaev (2016), Smith (2005)
- ▶ **Impact investing**
 - ▶ Barber, Morse & Yasuda (2018), Brest, Gilson & Wolfson (2018)
- ▶ **Contract theory**
 - ▶ Holmstrom & Milgrom (1991), Prendergast (1999), Hart & Moore (2008), Gilson, Sabel & Scott (2010)
- ▶ **This paper: first empirical analysis of impact investing fund contracts**
 - ▶ Insight into impact investing in practice
 - ▶ Setting to understand contracting with multiple goals

Our Sample

▶ 53 funds (38 MRS, 13 NMRS, 2 unknown) + 96 PC investments (70 MRS, 26 NMRS)



- ▶ Share characteristics with both PE and VC contracts – compare to both
- ▶ Most common PC industries: microfinance, agribusiness; locations: Africa, South Asia
- ▶ Fund characteristics similar to survey funds that did not provide contracts [\[More\]](#)

Contract Theory and Impact Investing: Four Predictions

1. Impact contracts should contain both descriptive (“aspirational”) and actionable (“operational”) impact terms
 - ▶ Actionable terms create enforceable rights (Bolton & Dewatripont 2005, Gompers & Lerner 1996)
 - ▶ Contracts also plays role in screening individuals and setting expectations (Prendergast 1999, Hart & Moore 2008)

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2. Impact terms should be relatively flexible (open ended terms), but more so in NMRS than MRS funds
 - ▶ When nature of good is uncertain, want flexible terms to allow for adjustments
 - ▶ But, when potential for disagreement is high, want rigid (binary) terms to avoid shading (Hart & Moore 2008)

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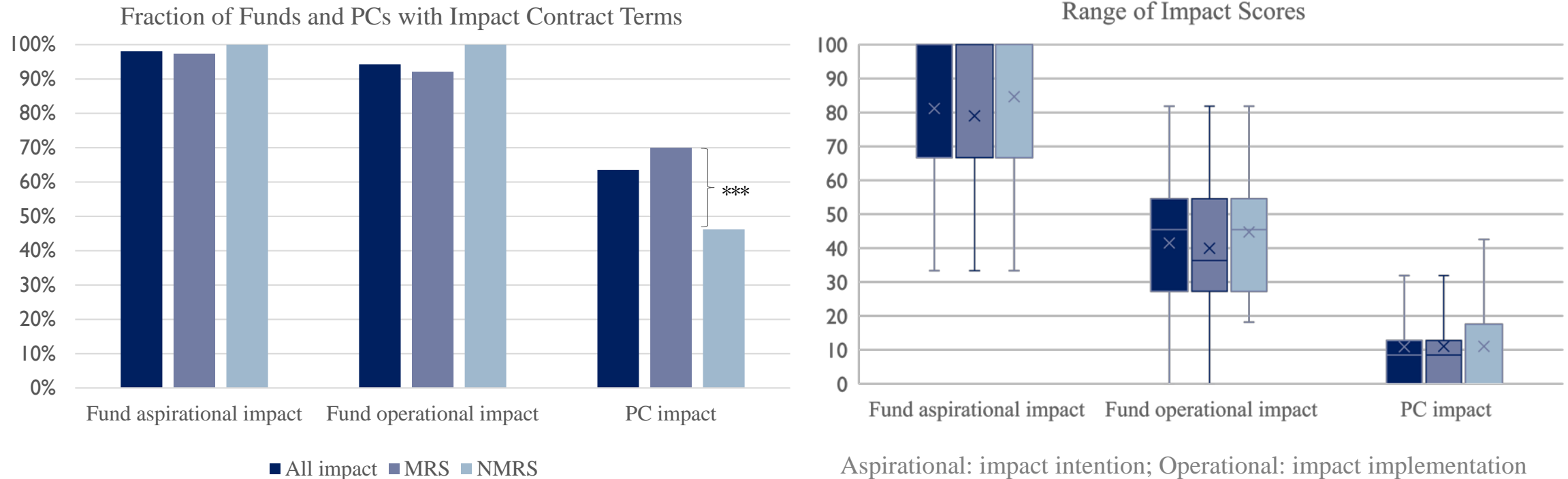
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 - ▶ When nature of good is uncertain, and potential for disagreement high, want governance processes that support flexible contracting – e.g. information rights, advisory committees (“participatory governance”) (Gilson et al. 2010)

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Most Contracts Contain Direct Terms, but Range Varies Widely

H1. Impact contracts should contain both aspirational and operational impact terms

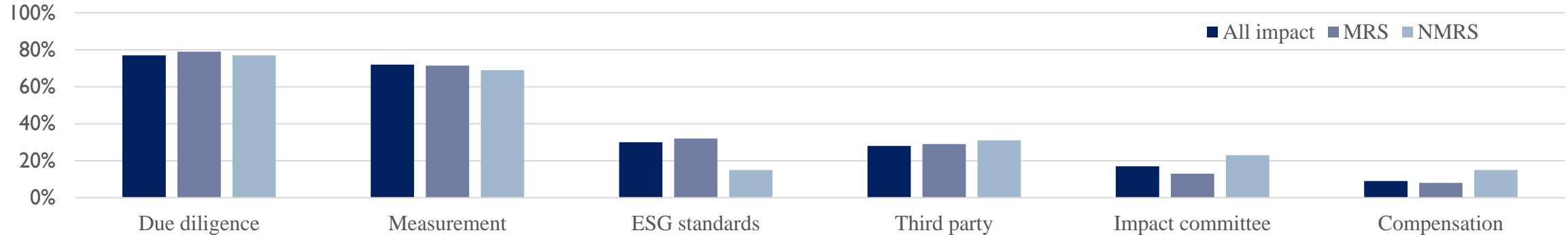


- ▶ At the fund level, impact terms are common, though range varies widely
- ▶ At the PC level, impact terms less common, especially for NMRS
 - ▶ Possible more embedded impact PCs lower need for enforceable rights and expectation setting

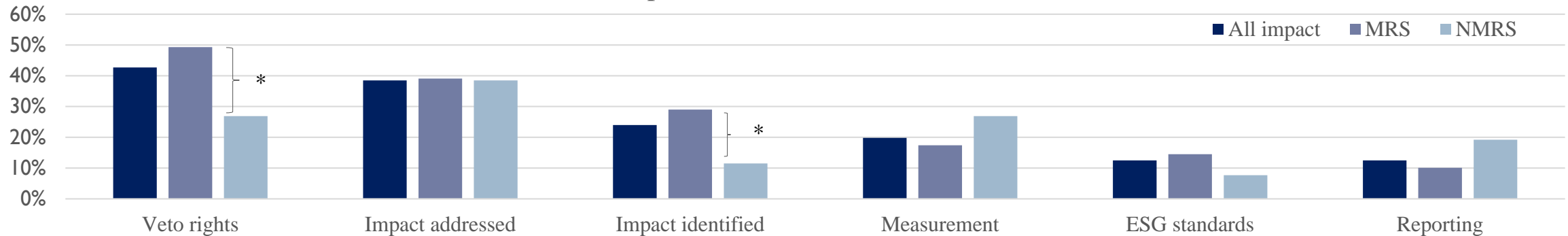
Funds Differ in How They Operationalize

H2. Impact terms should be relatively flexible, but more so in NMRS than MRS funds

Operational Impact Terms in Fund Contracts



Impact Terms in PC Contracts



- ▶ Terms tend to pertain to process and monitoring
 - ▶ MRS funds favor due diligence, ESG standards, veto rights (more rigid)
 - ▶ NMRS funds favor committees, measurement, reporting (more flexible)

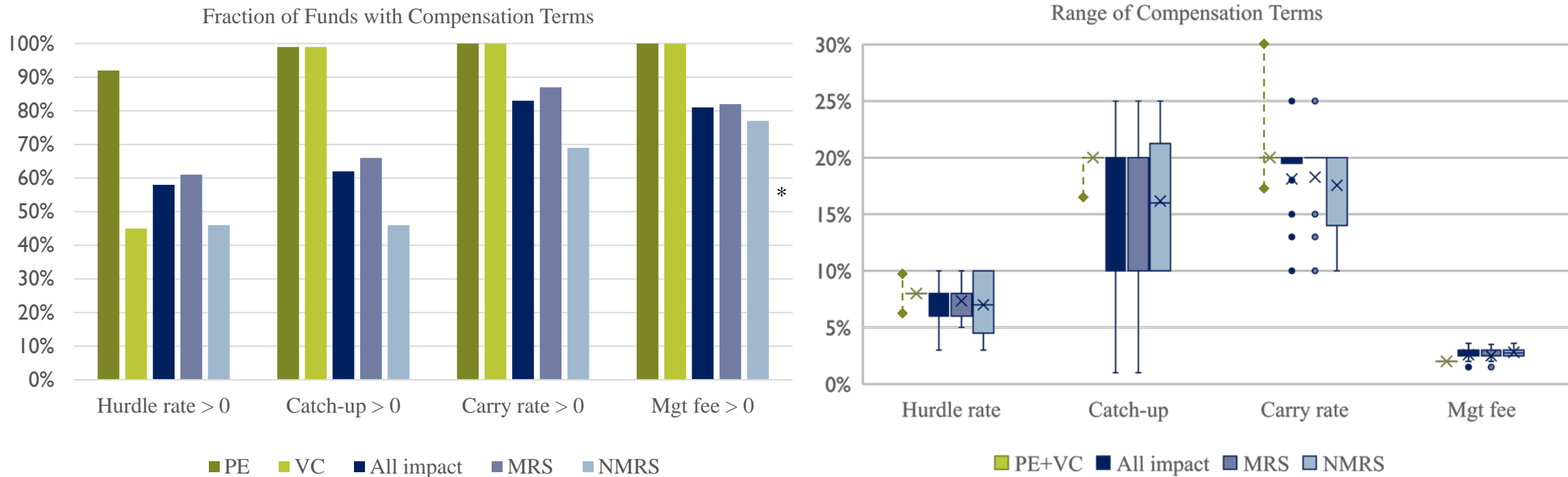
Contracting at Fund Level Flows Through to PC Level

	PC impact	
Fund aspirational impact	-0.1936** (0.0898)	-0.2231** (0.0865)
Fund operational impact	0.1880*** (0.0699)	0.2078*** (0.0683)
Num. GP-LP contracts	✓	✓

- ▶ GP-LP contracts are determined first when raising fund, then GP-PC contracts when finding deals
- ▶ If impact terms meaningful, more contracting at GP-LP level should correspond to more at GP-PC level
 - ▶ Agent subject to enforceable obligations will delegate obligations when she delegates tasks
- ▶ Operational terms at fund level correspond to impact terms at PC level
 - ▶ But not aspirational terms, which are negatively correlated with impact terms at PC level

Most Impact Funds Retain Traditional Compensation Structure

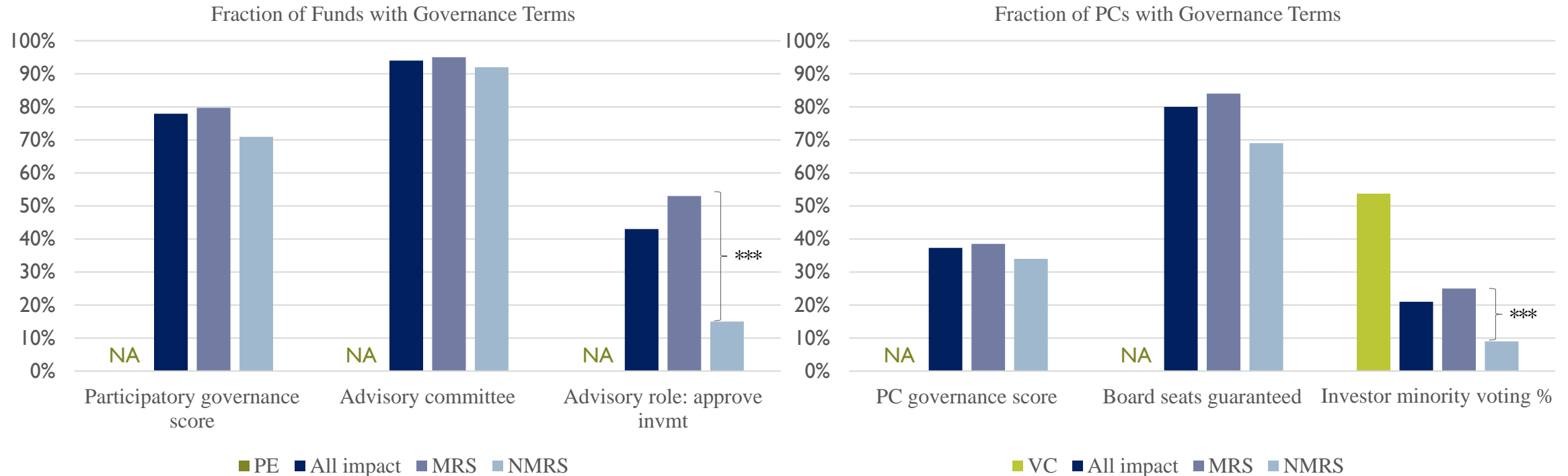
H3. There should be less incentive compensation in impact funds, and less in MRS than NMRS funds



- ▶ Fewer impact funds rely on waterfall compensation structure, but most still do
 - ▶ Hurdle, catch-up, and carry ranges also extend lower, but modes line up with non-impact
- ▶ MRS funds have more financial incentive compensation
 - ▶ Distorts activities toward profit seeking – unless compensated for elsewhere (e.g. direct terms, governance)

Participatory Governance Is Strong, Especially in MRS Funds

H4. Impact funds should have more tools for monitoring and exercising “voice,” especially MRS funds



- ▶ At fund level, advisory committees much more common for impact than non-impact
 - ▶ Overall score significantly higher for MRS than NMRS, consistent with theory
- ▶ At PC level, impact funds contract for board seats very often
 - ▶ May be necessary given minority position

Discussion

- ▶ Addition of impact goal is reflected in multiple places in contracts
 - ▶ Direct terms, governance, less so compensation
- ▶ Differences in MRS relative to NMRS impact funds
 - ▶ More direct terms in GP-PC contracts; relatively more rigid terms at both levels
 - ▶ More financial incentive
 - ▶ More oversight (advisory committees, seats on board)
- ▶ Existing theories explain part of the results, especially impact v. non-impact
 - ▶ Flexible contracting, multitasking, braiding
- ▶ But, no unified theory, especially for MRS v. NMRS distinctions
 - ▶ Relative utilities over profit and impact seem key

Framework for MRS v. NMRS Contracting – Hidden Preferences

- ▶ Suppose portfolio can have 1 or 2 units of impact, at either cheap or expensive price
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 - ▶ Medium: value impact, but ‘price-sensitive’ – buy 2 units of impact if ‘cheap’, 1 unit if ‘expensive’
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 - ▶ E.g. Low type LPs hire Low type GPs to manage non-impact funds, always purchase 1 unit
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- ▶ MRS impact funds require additional contracting, relative to NMRS and non-impact
 - ▶ Only they cater to price-sensitive investors
 - ▶ Require oversight for investors to learn true tradeoff, other terms to screen, protect baseline, provide incentives

Conclusion

- ▶ First study of contracts in impact investing funds
- ▶ Few funds tie compensation to impact
 - ▶ Compensation most often tied to financial incentives, especially in MRS funds
- ▶ Funds contract directly on impact in other ways
 - ▶ Operational impact reasonably high at fund level, mixed at PC level
 - ▶ Impact terms are generally flexible, but relatively more rigid in MRS funds
- ▶ Emphasis on ‘participatory governance’ in impact funds
 - ▶ At fund and PC level, mechanisms for communication, supervision important
 - ▶ Especially pronounced in MRS funds, where balance of goals delicate

Appendix

Representativeness of Contract Sample

▶ Survey responses of funds with and without contracts are similar

	<u>Provided Contracts</u>			<u>Did Not Provide Contracts</u>			Difference
	N	Mean	Median	N	Mean	Median	t-statistic
Market-rate seeking	50	70%	1	48	71%	1	0.09
Target net IRR	37	15%	15%	22	15%	15%	-0.07
Vintage year	50	2008	2009	39	2006	2009	-0.94
Fund's initial term (yrs)	40	9.0	10	25	9.2	10	0.38
Committed capital (\$M)	47	100.0	31.8	36	199.4	40	1.50
Num. companies in which fund has invested	45	14.9	8	47	14.2	11	-0.14
Num. funds currently managed by firm	31	3.6	2	29	2.1	2	-1.52
Num. funds managed by most senior firm GP	29	8.1	4	25	3.7	3	-1.82*

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Impact Due Diligence: Sample Language (Fund)

“The Fund will conduct comprehensive due diligence on all potential investments in order to ascertain their financial situation, management practices, operational procedures, market potential and/or **social impacts.**”

“Prospective portfolio companies will be evaluated on five principal criteria: management, growth capacity, competitive advantage, attractive return and **social benefit.**”

“In order to ensure that the Company's funds are invested in businesses that offer the opportunity for growth and development in the Region, the Company, similar to ECD, requires that any applicant for a loan or an investment demonstrate that **at least 50% of the jobs created or retained** as a result of the proposed loan or investment will be in a county in a region that (1) **county median for family income is less than 80% of national median;** (b) **20% or more of county residents live at or below the poverty level;** (c) **the county rate of unemployed exceeds the national rate by 50% or more;** (d) **the rate of decline in county population between the years 1980 and 1990 was 10% or more.**”

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Impact Measurement: Sample Language (Fund)

“... on a per-rental unit basis taking into account all rental units in all Properties, at least 40% of all tenants in all Properties are at or below 60 % of the area median income applicable to the Property in which their rental units are located, and/or at least 20% of all tenants in all Properties are at or below 50% of the area median income applicable to the Property in which their rental units are located, and “area median income” as to each Property shall be determined by reference to accepted low income housing industry data references.”

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Adherence to ESG Standards: Sample Language (Fund)

“The Fund and any related fund shall procure that each Investee Company over which it has Effective Control signs an undertaking confirming that It will operate in accordance with the ESG Investment Code. ... representatives of the Shareholders shall have the right to visit, upon a reasonable notice, any of the premises where the business of such Investee Company is conducted and to have access to its books of account and records to the extent reasonably necessary to monitor compliance with the ESG Investment Code.”

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Impact Committee: Sample Language (Fund)

“The **duties of the Impact Committee** shall be those enumerated in the Investors’ Agreement, including, without limitation, **screening of early stage investment opportunities** pursuant to the Terms of Reference (including ensuring **alignment with the Investor Charitable Goal Requirements**) ... investment opportunities must be approved by the Impact Committee on a no objections basis (i.e., **each voting member must either affirmatively approve or state that they have no objection** to such investment opportunity). Any investment opportunity that does not meet the screening criteria set forth in the Terms of Reference shall not be presented to the Investment Committee.”

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Compensation Tied to Impact: Sample Language (Fund)

“The closing of the escrow account for the **distribution of the Carried Interest** in favour of the Participating Shareholders will be **subordinated on the achievement of the Social Returns** on the basis of the favourable **opinion of the Advisory Committee**. In case of negative opinion the Carried Interest will contribute to the Fund for the distribution to Limited Shareholders.”

“The Manager shall further be entitled to an **annual incentive fee** calculated at fifty basis points (0.5%) of invested capital at the end of each year, which fee shall be **based upon the social and developmental returns achieved** as a result of the Company's investment in the Portfolio Companies.”

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Veto on Change in Business Plan: Sample Language (PC)

“For as long as Investor owns an interest in the Company, and promptly after submission to Investor of each draft annual budget, the Promoter and Investor shall discuss the business plan, and any material change from the previously approved business plan shall require written approval by the investor...”

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Impact Addressed: Sample Language (PC)

“The Final Agreements will include language assuring adherence to the US Foreign Corrupt Practices Act and the Investor’s Investment Codes, which require compliance with environmental covenants, IFC Performance Standards, ILO Core Conventions and the UN Declaration of Human Rights, among other aspects.”

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Impact Defined: Sample Language (PC)

“[PC] shall utilize the proceeds of the Offering in furtherance of its primary objective to make available regular, reliable and efficient financial services to the economically active urban and rural poor, enabling them to become self reliant and meet their aspirations for a better and secure future.”

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Adherence to ESG Standards: Sample Language (PC)

“[PC] shall comply with the Social and Environmental Guidelines of the International Finance Corporation.”

“The Company undertakes to comply with all [country] legal provisions on all applicable environmental laws as well as the ESG.”

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Impact Measurement & Reporting: Sample Language (PC)

“The Company hereby agrees to request and secure an impact certification on behalf of the Global Impact Investing Rating System (“GIIRS”) within 3 (three) months post-Closing.”

“Purchasers will be provided with ... a series of measures of social impact as agreed by the Company and Purchasers, as Purchasers may reasonably request. Purchasers will be entitled to inspection rights of the books and registers maintained by the Company.”

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