TYING FUND MANAGER COMPENSATION TO IMPACT OUTCOMES

In a typical private equity fund, a general partner's (GP) financial compensation is linked to the fund's financial performance in the form of a carried interest – a percentage of the earnings of the fund. In the context of impact investing, a fund manager promises both financial and social returns, yet compensation is still traditionally tied only to financial performance. This traditional compensation structure leaves out financial incentives for the GP to meet the fund's stated social impact objectives.

In recent years, tools and methodologies to monitor and measure impact have become more numerous, more sophisticated, and to some extent routinized. What was once an ad hoc playland of what to measure, how to measure, and who to pay to measure, has matured into an ecosystem of metrics.

The progress in impact measurement ought to make it easier for GPs to implement a compensation structure that takes into account the social impact achieved.

Why this matters

There are multiple good reasons for tying compensation to social impact outcomes.

Having a financial stake in the impact performance of their fund provides a strong incentive for fund managers to give impact a proper weight in the investment decisions and administration of the fund.

When two investment options are available – one that would exclusively maximize the financial returns versus one that provides both types of returns – the right incentive

"In a new and growing market like impact investing, it is important to ensure maximum alignment of interests among all players involved in its development. ... I believe it is time to link the compensation of managers to social impact, the same way it is linked to financial return, to guarantee that everyone is truly accountable for delivering all the promises that impact investing is making."
- Daniel Izzo, Vox Capital
Stanford Social Innovation Review

structure becomes paramount. A sole financial incentive may skew the fund manager's decision toward an outcome that would be disfavored by the LPs from an impact standpoint (assuming a trade-off). Conversely, if part of her compensation was tied to the impact outcome, the evaluation would be better aligned with that of the LPs – including where the decision was to invest away from impact and toward financial return.

"DOEN Foundation, an anchor investor in the fund, challenged us to tie the carry to the fund's impact. We embraced the idea because this is what we are about – we are a mission-first impact fund."
– Harlan Mandel, MDIF

Such a compensation structure also incentivizes fund managers to have a clear definition of impact and a rigorous impact measurement framework at the outset, avoiding the vagueness that still plagues many impact funds.

If fund manager compensation is tied to social impact, limited partners who care about the social impact are reassured that impact performance is given proper weight in the investment decisions and administration of the fund.

So, who is doing it?

Embedding impact into a compensation structure can also differentiate an impact fund by signaling to potential LPs a stronger commitment by the GP to the fund's stated impact goals.

While it's not an industry practice, several impact investment fund managers have adopted compensation structures that tie GP's financial returns to impact performance.

We review the terms of the compensation of three pioneering fund managers in the following section.

Vox Capital Impact Investing Fund I

Fund Manager: Vox Capital

Fund Terms: Size: R$84.3 million | Life: 10 years | Inception: 2012 | Target Net IRR: 15%

Impact Focus: Vox Capital supports innovative scalable solutions to serve the Brazilian base of the pyramid population in the areas of education, health, housing, financial services, and employment.

Impact Assessment Framework: For each company in the fund's portfolio, Vox defines metrics to monitor impact and gathers anecdotes of impact cases. This process is within Vox's budget and has virtually no cost. Vox applies GIIRS ratings to all its portfolio companies. The costs associated with this process are covered by the IDB's Multilateral Investment Fund, which is one of the fund's early LPs. GIIRS is also the only measure Vox is currently using to affect its compensation. The targets for GIIRS are defined by the Shareholders' Assembly, based on the manager's recommendation.

Vox is developing, in partnership with J-PAL, a methodology to measure impact outcomes and is using one of its portfolio companies as a pilot. The idea is that the methodology is affordable and effective enough for the investee companies to incorporate it in their annual budgets (as they incorporate the costs of an annual audit).

Impact-Based Incentive Structure: Vox uses GIIRS as a proxy for the GP's carry compensation. The GIIRS targets for the fund are defined by the Shareholders' Assembly, based on Vox's recommendation. The carry is divided in two components: 10% for the financial performance and 10% for the social impact performance. GP receives the full 20% carry only if both the financial return and the social impact expected by investors are met. If the manager does not reach the minimum expected social impact level, the manager is entitled to only 10% carry. If the GP does not earn the full carry, the remaining monetary proceeds will be distributed to the LPs.

Costs to monitor impact are covered by the IDB's Multilateral Investment Fund, one of the fund's early LPs.

Emerging Media Opportunity Fund

Fund Manager: Media Development Investment Fund (MDIF)

Fund Terms: Size: US$30 million | Life: 10 years | Inception: 2016

Impact Focus: MDIF supports independent media companies in countries where access to free and independent media is under threat, enabling them to develop sustainable businesses. EMOF focuses on broadcast and digital news and information companies primarily in Africa, Asia, and Latin America.

Impact Assessment Framework: MDIF partnered with DOEN Foundation and Steward Redqueen to adapt its existing impact framework to the fund and establish a formula to incorporate impact into MDIF's carry calculation. MDIF calculates the fund's total impact score based on impact performance of its investments (media outlets) across five metrics: country mission fit, investee mission fit, increased reach, impact on society, and sustainable exit. The two mission fit metrics are evaluated at the outset of the project, impact on society is assessed once during the investment term, increased reach is measured from the start to the end of the investment, and the sustainability of the exit is assessed at the end of the project.

The fund manager can assign full credit (20 out of 20 points), partial credit (10 out of 20 points), or no credit (0 out of 20 points) for each metric based on the level of impact achieved. The final results are reviewed and certified by MDIF's independent Board of Directors. Costs associated with the impact measurement framework are covered by EMOF's management fee.

Impact-Based Incentive Structure: The fund has a standard base carry of 20%, which is adjusted downwards in direct proportion to the total impact score achieved. If impact targets within all five metrics are fully met, the impact score is 100 (5x20) and GP gets the full carry of 20%. If, for example, the fund gets a score of 20 in two impact categories, a score of 10 in one category, and a score of 0 in two other impact categories, the total impact score would be 50 and GP would get only 50% of the base carry or 10%. In the event that EMOF does not earn full carry, the unearned funds will be distributed among the LPs.

To the best of our knowledge, EMOF is the only fund that takes the mission-aligned exit into account as part of the final carry calculation.

The Global Financial Inclusion Fund (GFIF)

Fund Manager: GAWA Capital Partners (GAWA)

Fund Terms: Size: €33 million | Life: 10 years | Inception: 2014 | Target IRR (net): 7-8%

Impact Focus: The GFIF invests in microfinance institutions with the goal of creating a measurable social impact for low-income communities by providing financial services (loans, savings accounts, and micro-insurance). The fund is expected to invest 60% in debt and 40% in equity with a regional focus on Latin America, Asia, and Sub-Saharan Africa.

Impact Assessment Framework: GAWA measures the GFIF's social performance using 25 metrics that reflect the Smart Campaign's Client Protection Principles and are based on IRIS metrics. The manager assigns a score of 0 to 1 for each metric. The score is updated quarterly and the GFIF's portfolio score is calculated using the weighted average score over the life of the fund's investments. The score for each investment will be audited by an independent firm chosen by investors. The framework was set up in collaboration with investors and costs associated with the audit are covered by the fund.

Impact-Based Incentive Structure: The fund has a base carry of 15% which can be adjusted upwards to a maximum of 20% in direct proportion to the average impact score achieved. If, for example, the fund meets its financial hurdle and gets an average impact score of 0.8, the GP would get a distribution of an additional 4% on top of 15% for a total carry of 19%. If impact targets are not fully achieved, the portion of the potential carry not distributed to the GP will be distributed to the limited partners.

What to consider

Short-term versus long-term impact performance: The two types of GP compensation that can be linked to social performance are the bonus (derived from the annual management fee and based on short-term performance) and the carry (based on long-term performance). To determine an appropriate structure, it helps to assess the extent to which expected financial returns may contribute to the bonus and carry. For example, if a fund manager anticipates high profits upon liquidation of the fund's holdings (which will create a substantial pool of capital for carried interest distribution), incorporating impact performance in the carry might be a stronger financial incentive than for a fund that expects relatively low financial returns. Tying impact performance to the annual bonus or the management fee is appropriate if the fund's investments are designed to meet specific short-term impact targets (on an annual basis) and creates a stronger financial incentive if the fund expects relatively low returns upon liquidation of its investments and/or the fund is large enough for the management fee to represent a meaningful portion of the value proposition for the GP. Long-term impact performance can also be tied by ensuring that a mission-aligned exit is part of the carry calculation.

Determining the size of compensation linked to social performance: Impact fund managers have tied various percentages of their financial compensation to social performance. In some funds, 100 percent of the GP bonus or the carry is linked to social performance while in others an additional bonus or a percentage of extra carry (e.g. 10 percent) can be earned as a result of achieving certain impact outcomes on top of the GP bonus or carry that is based on financial performance.

Penalizing versus rewarding GPs: GPs can either be penalized or rewarded based on impact performance by either decreasing or increasing their compensation depending on impact outcomes. That said, a fund that provides extra percentage points s of carried interest above the traditional 20 percent based on the achievement of social impact outcomes appears to signal that the impact is not baked into the DNA of the fund. Likewise, it would be odd for a fund that claims to achieve above market rates of return based on its impact thesis to demand extra carry for achieving that impact.

Using monetary proceeds not distributed to GPs due to inability to meet impact targets: This money can either be returned to LPs or donated to a third-party mission-aligned company (e.g. a non-profit selected by the GP). If the idea is to achieve a certain impact, and this does not happen through the fund's investments, it may make sense to use the proceeds to support a different approach to achieving that impact, such as a contribution to a mission-aligned non-profit; the return of the extra carry to the LPs does not in itself advance the impact achieved. In an extreme case, if the failure to achieve impact means a larger percentage of earnings for the LPs, one could see a misalignment of LP incentives towards lesser impact.

Defining and monitoring impact: It is critical to establish clear impact metrics and targets at the outset. GP and LPs can jointly agree on impact performance measurement and this can be part of the pre- and post-investment negotiations. Some fund managers engage an independent impact expert; others rely on an internal committee. What matters is for the impact to be clearly defined upfront (ensuring that what really matters is measured and adequate proxies are used) and for the measurement methodology to be feasible. Monitoring impact performance over the life of the fund can be resource-intensive and costly. While some GPs pay for impact reporting and audit out of the management fee, others reply on a technical assistance facility financed by LPs or a mission-aligned third party. If the fund is already measuring the impact of its portfolio companies, it should not create substantial additional costs to devise a way for that measurement to be factored into the financial compensation calculations.

What you can do

As a fund manager or GP: consider ways in which your compensation can be tied to impact. If you don't do it, be prepared to explain why.

As an asset owner or limited partner: ask any potential fund manager why the carry is not tied to impact, and familiarize both the fund managers and your asset managers with the issue. Promote this practice as appropriate across all your funds.

This content was developed based on the collaborative work of the Transform Finance Investor Network (TFIN), conversations with fund managers, and Global Impact Investing Network's (GIIN) Issue Brief *Impact-Based Incentive Structures*, in collaboration with Marina Leytes and Oscar Perry Abello. To learn more about the specific case of MDIF and a detailed discussion of the above issues, please refer to the recording of the TFIN webinar *Tying Fund Manager Returns and Impact Outcomes* at http://transformfinance.org/investor-resources.

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