Contracts with Benefits: The Implementation of Impact Investing

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Christopher Geczy, Wharton School, University of Pennsylvania
Jessica Jeffers, University of Chicago, Booth
David Musto, Wharton School, University of Pennsylvania
Anne Tucker, College of Law, Georgia State University

Question

- Rapid growth in capital allocated to socially responsible investing
  - $70 trillion committed to ESG under UNPRI, up from $7 trillion in 2006
  - Public markets (often screen-out) and private markets (more active strategies)

- Our setting: impact investing funds
  - PE & VC funds targeting social benefit *and* financial returns
  - Global Impact Investor Network: $228 billion AUM and $36 billion in deals, almost double over previous year

- Many disagreements and unknowns
  - Concerns about greenwashing, unknown returns
  - Difficult to define goals and measure performance on ‘social benefit’; difficult to observe for researcher

- How do contracts reflect dual goals of social benefit and financial returns?
  - Predictions from contract theory for structure and context
  - First empirical analysis of impact investing fund contracts

Empirical Approach

- Hand collect 196 legal documents from impact investing funds
  - Collaboration with Wharton Social Impact Initiative, soon HBS
- Contract with limited partners (LPs) and portfolio companies (PCs)
  - 100 GP-LP documents for 51 funds (PPMs, limited partner agreements, side letters)
  - 96 GP-PC documents for 93 portfolio companies (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
- Compare contracting patterns for impact and non-impact funds, and for MRS and NMRS impact funds
  - Individual provisions and aggregate 'scores' for different dimensions (e.g., impact, governance)

Findings

1. Both descriptive and actionable contract terms around impact
   - ✓ Consistent with theory
2. Contracting around impact is ‘flexible’, especially in NMRS funds
   - ✓ Consistent with theory
3. Most impact funds, especially MRS, retain traditional compensation structure
   - × Not consistent with theory
4. Impact funds have many asset restrictions, but fewer restrictions on outside activities
   - × Consistent on asset restrictions, not on outside activities
5. Impact funds have more ‘participatory’ governance, especially MRS funds
   - ✓ Consistent with theory

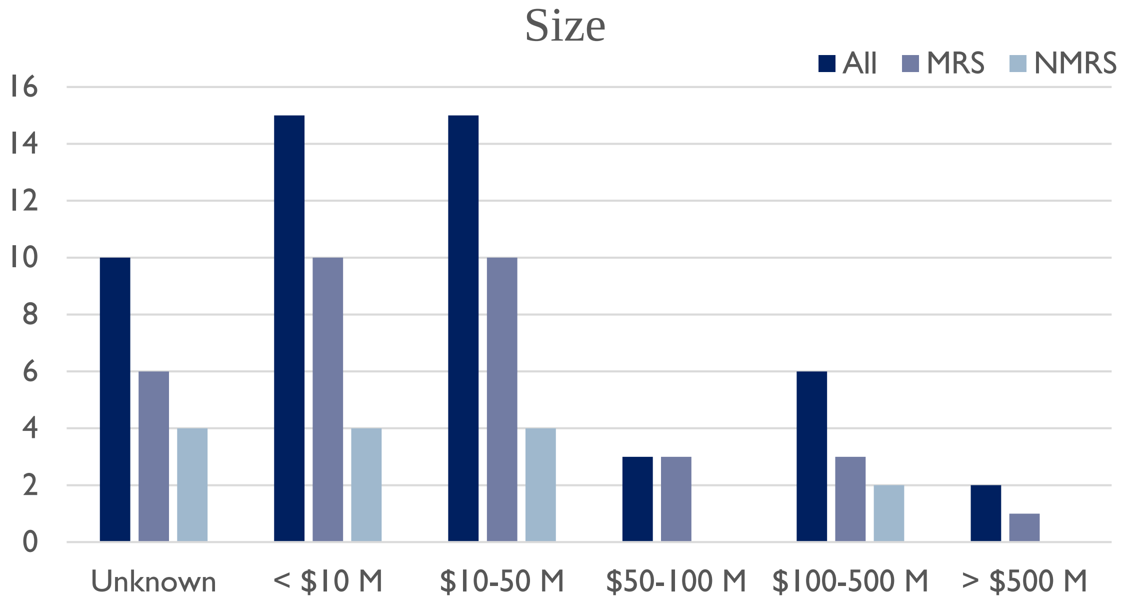
Literature

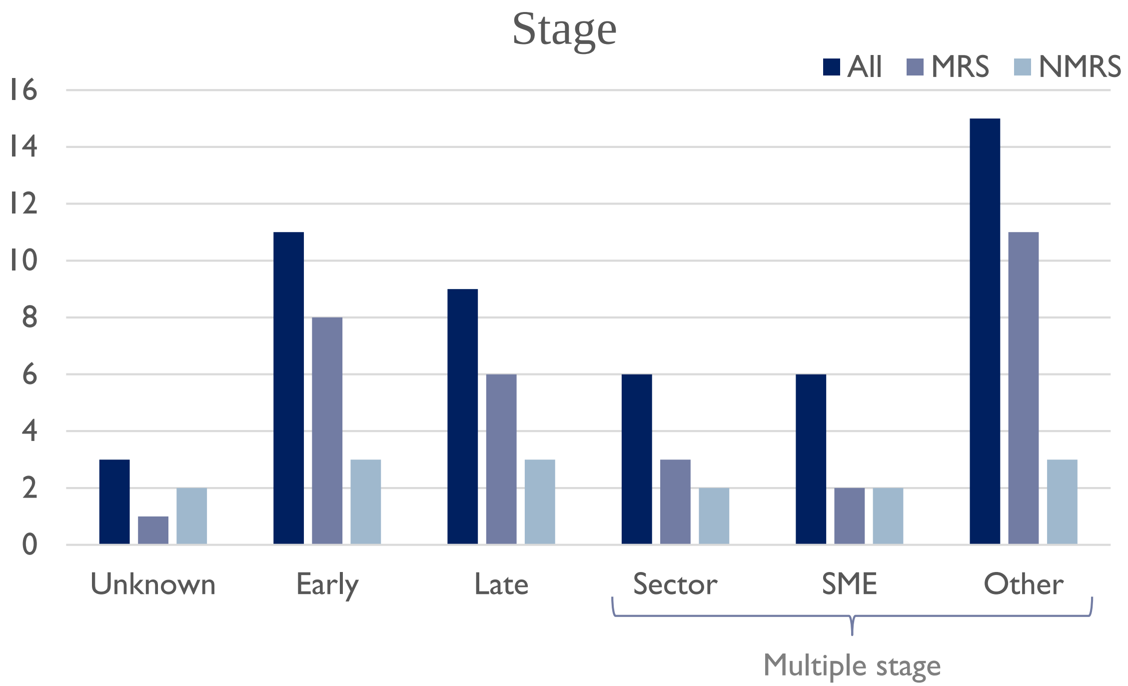
- Private equity and venture capital
  - Kaplan & Schoar (2005), Phalippou & Gottschalg (2009), Kaplan & Stromberg (2009), Cummings & Walz (2010), Da Rin, Hellmann & Puri (2013), Da Rin & Phalippou (2017), and more
- PE and VC contracts
  - PE: Gompers, Kaplan & Mukharlyamov (2016), Metrick & Yasuda (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)

- Include both PE and VC contracts in 'non-impact' comparison group
  - Impact funds share characteristics with both; invest across stages, often in minority position
  - When available, show separate PE and VC comparison points

Our Sample

- 51 funds: 33 MRS, 14 NMRS, 4 unknown; 96 PC investments: 69 MRS, 26 NMRS, 1 unknown





- Documents 1988-2016, median year 2010
- 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: Five Predictions

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   - 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), and 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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5. Impact funds should have more tools for monitoring and exercising "voice," especially MRS funds
   - 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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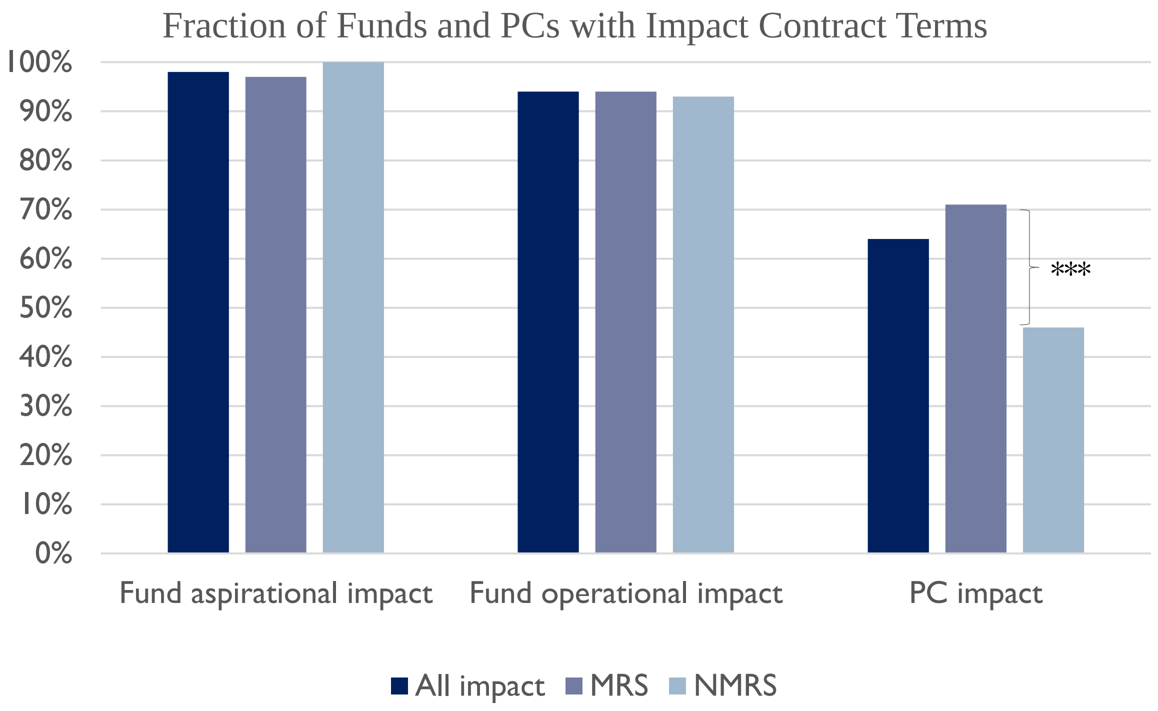
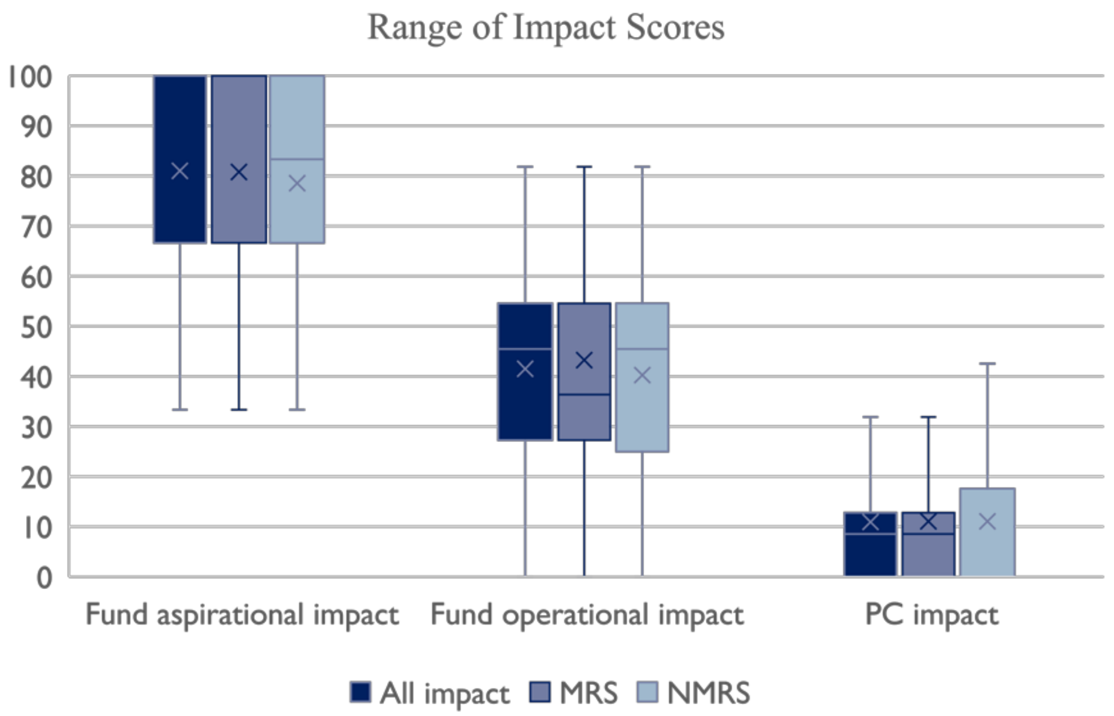
Most Contracts Contain Direct Terms, but Range Varies Widely

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

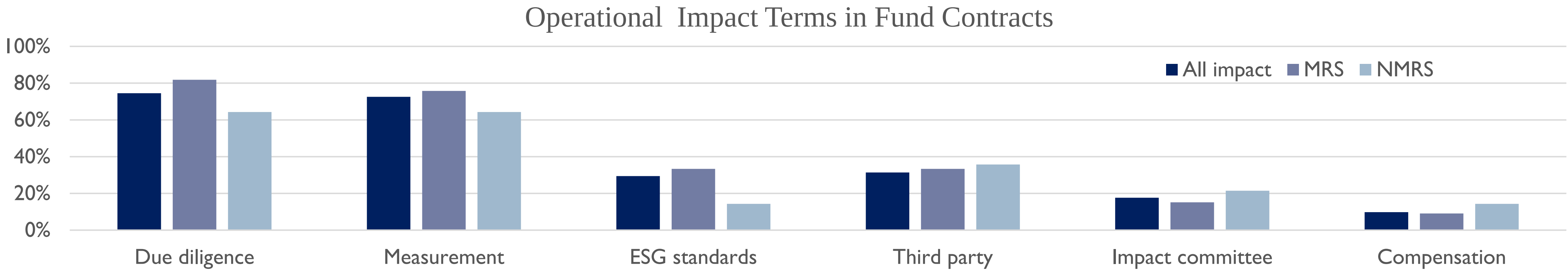


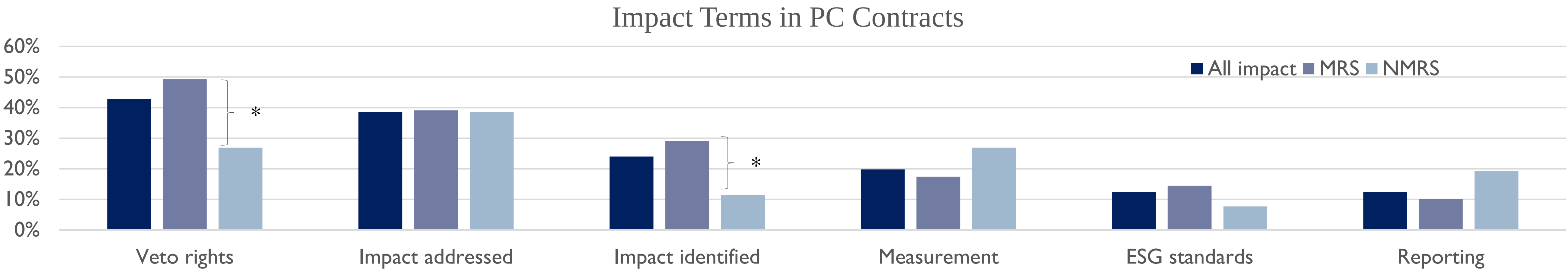


- At the fund level, impact terms are common, though range varies widely
- At the PC level, impact terms less common, especially for NMRS
  - More embedded impact PCs, lower need for enforceable rights, expectation setting?

Funds Differ in How They Operationalize

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

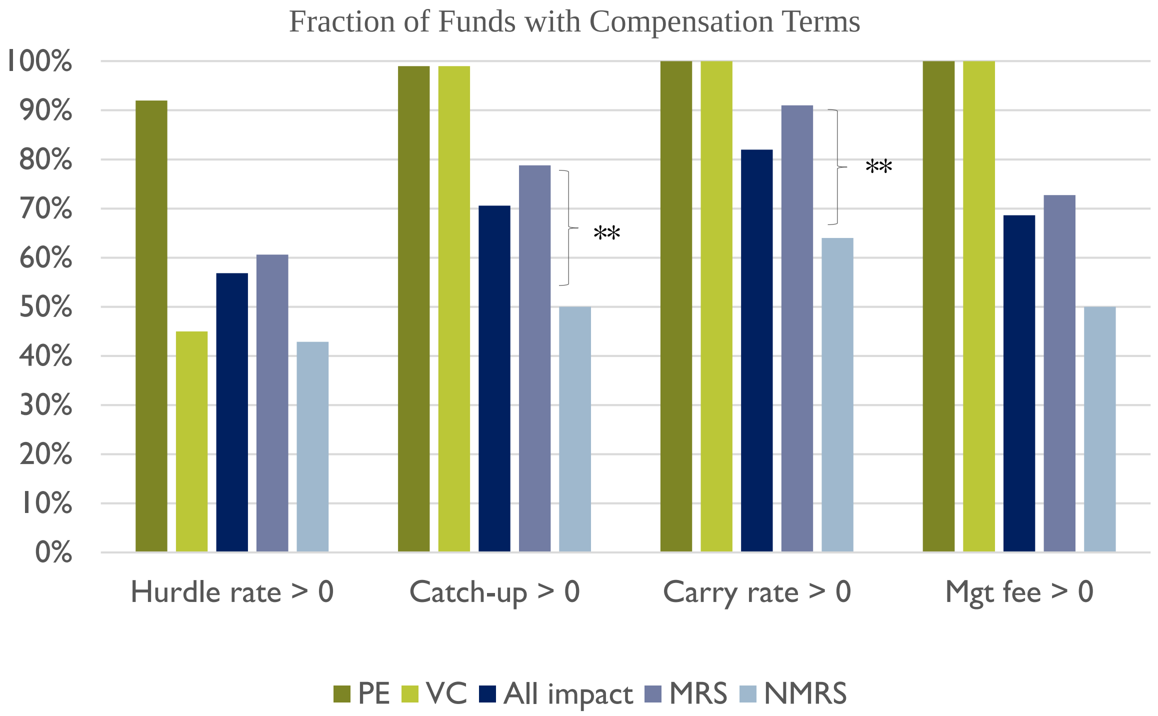


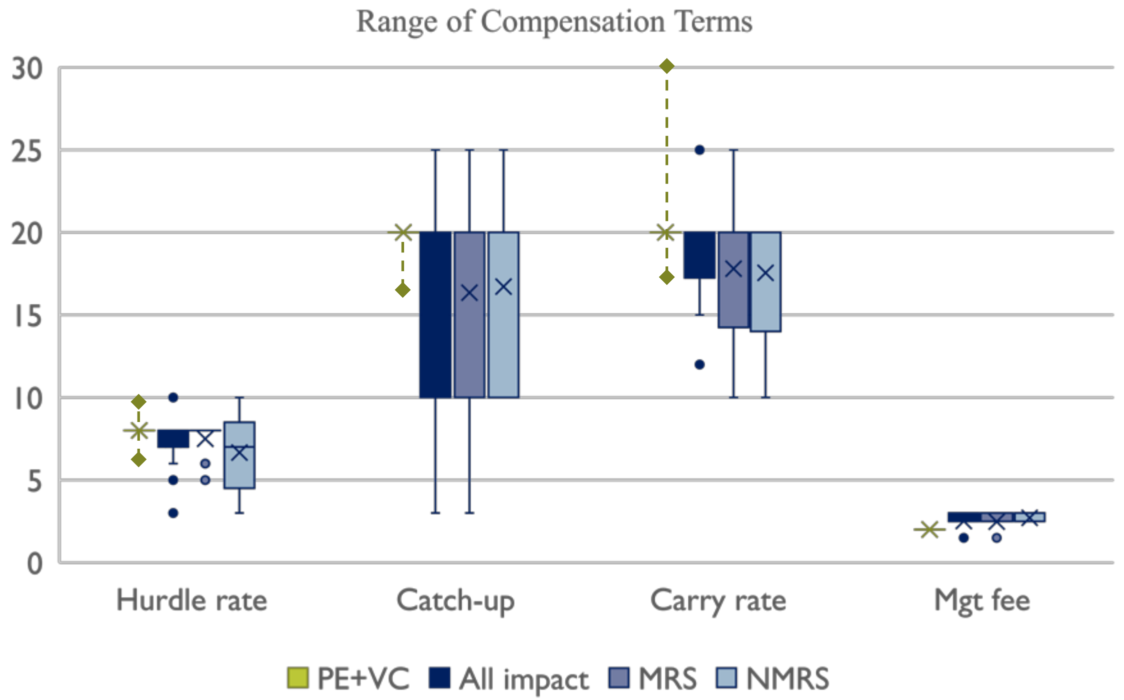


- Terms tend to pertain to process and monitoring
  - MRS funds favor due diligence, ESG standards, veto rights (more rigid)
  - NMRS funds favor committees, measurement, reporting (more flexible)

Most Impact Funds Retain Traditional Compensation Structure

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

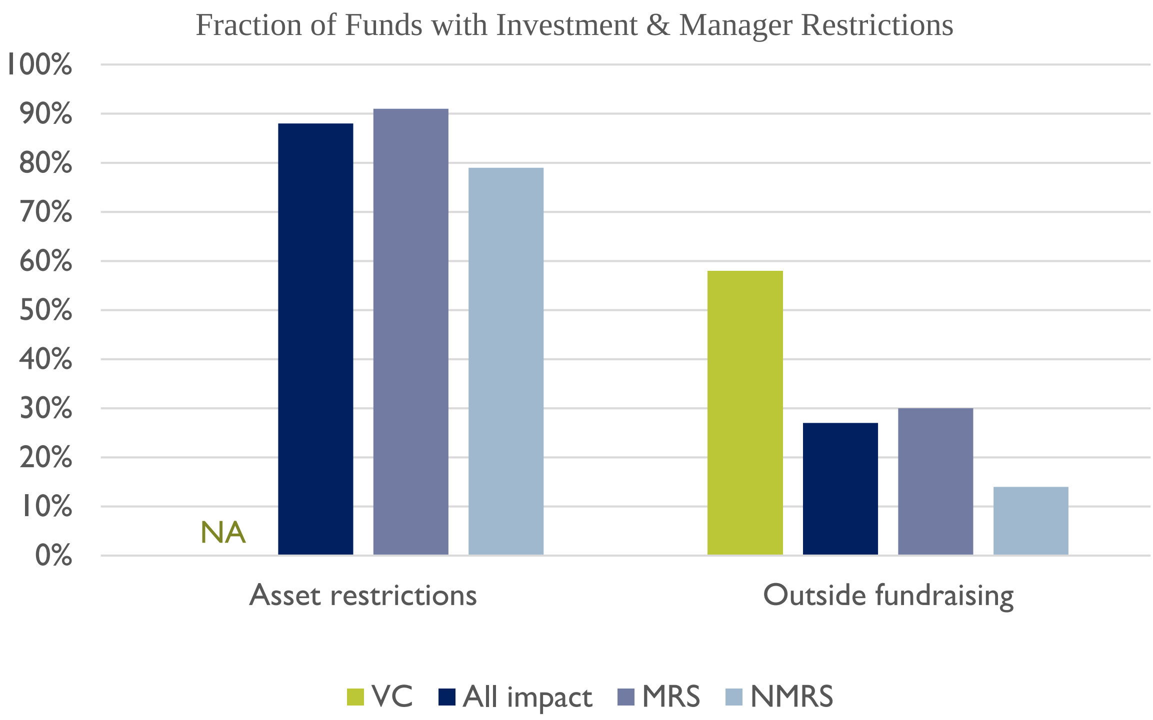


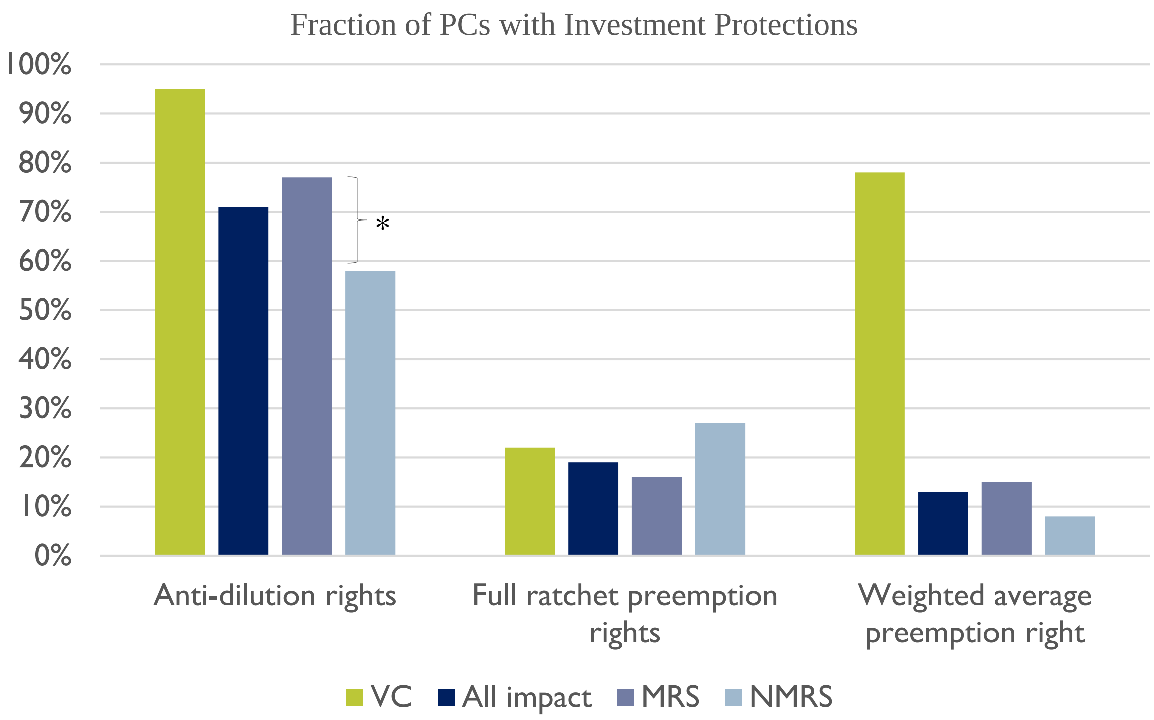


- Fewer impact funds rely on waterfall compensation structure, but most still do
  - Hurdle, catch-up, and carry ranges also extend lower, but modes line up with non-impact
- MRS funds have more financial incentive compensation
  - Distorts activities toward profit seeking – as desired?

Many Impact Funds Restrict Investments, Few Restrict Outside Activities

H4. Impact funds should have more restrictions on outside activities, and on investable assets

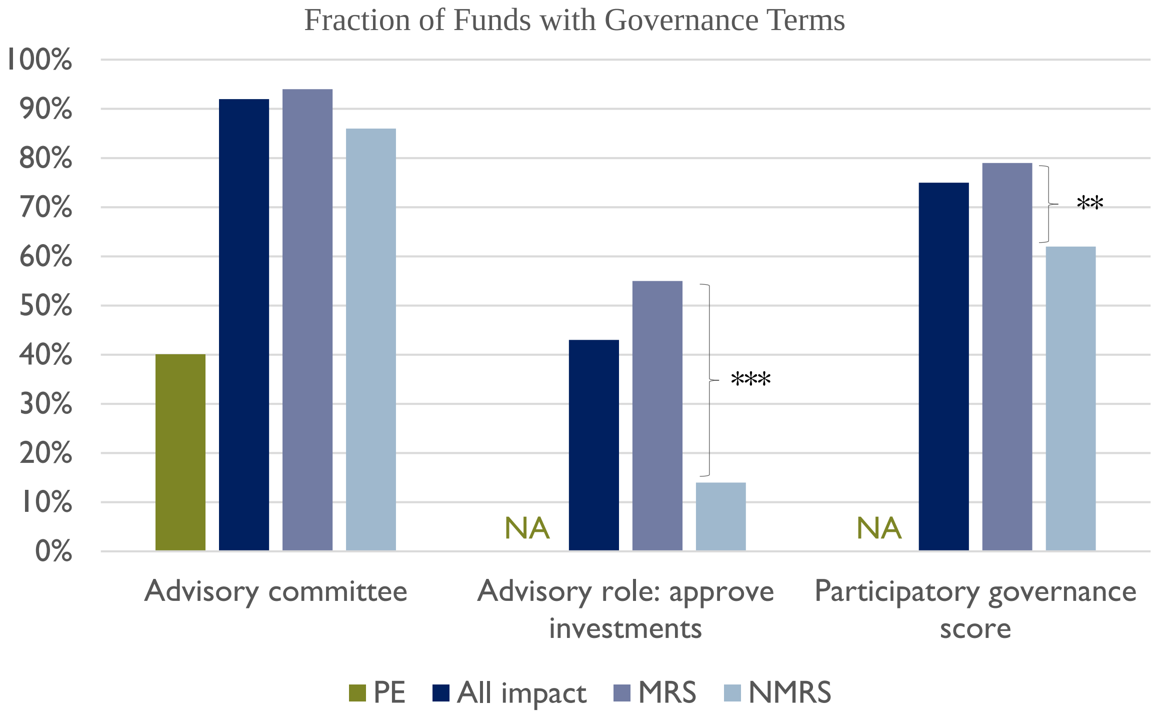


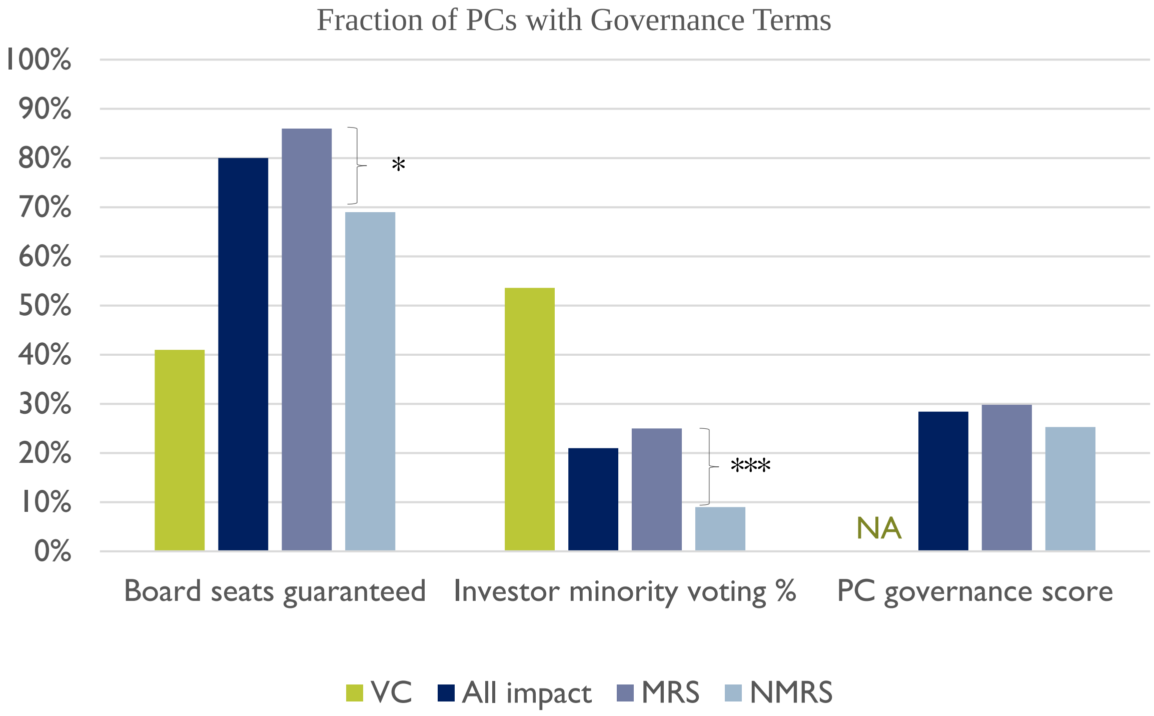


- High incidence of asset restrictions consistent with additional constraint
- Low incidence of outside activity restrictions inconsistent with theory
  - May be necessary given small size of funds
- Fewer restrictions at PC level also counter to theory

Participatory Governance Is Strong, Especially in MRS Funds

H5. 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

Conclusion

- First study of contracts in impact investing funds
- Funds contract directly on impact, with both aspirational and operational terms
  - Operational impact reasonably high at fund level, mixed at PC level
  - Impact terms are generally flexible, but relatively more rigid in MRS funds
- Compensation largely tied to financial incentives, though not for all 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

	Provided Contracts			Did Not Provide Contracts			Difference
	N	Mean	Median	N	Mean	Median	t-statistic
Market-rate seeking	43	67%		54	72%		-0.51
Target net IRR	33	15%	15%	26	14%	15%	0.3
Vintage year	44	2008	2009	45	2007	2009	0.59
Fund's initial term (yrs)	35	9.3	10	30	8.9	10	0.68
Committed capital ($M)	42	92	28	41	195	42	-1.57
# companies in which fund has invested	40	14	8	52	15	12	-0.05
# funds currently managed by firm	29	3.7	2	31	2.1	2	1.64
# funds managed by most senior firm GP	27	8.4	4	27	3.6	3	2.02**

Back

Sample Language: Impact Committee (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). The Impact Committee screening of such investment opportunities shall occur after a preliminary initial due diligence review by the Manager and prior to the presentation of such investment opportunities to the Investment Committee. Such 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 (and, for the avoidance of doubt, the Company shall not invest in any such investment opportunities). Opportunities must be resubmitted to the Impact Committee for review if subsequent due diligence reveals new and material information that could undermine previous screening conclusions of the Impact Committee"

Sample Language: Impact Due Diligence (Fund)

"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."

"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."

Sample Language: Compensation Tied to Impact (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."

Sample Language: Impact Report Obligation (PC)

"Deliver to Investor not later than forty-five (45) days, or such longer period as Investor deems reasonably appropriate following the end of the Company's fiscal year, data on the number and nature of jobs created during the fiscal year."