IMPACT-BASED INCENTIVE STRUCTURES

Aligning Fund Manager Compensation with Social and Environmental Performance

DECEMBER 2011
In traditional private equity funds, the compensation for general partners (GP) is driven by incentives linked to the funds' fundamental objective—the maximization of profits for their investors. Many impact investment funds have adopted this compensation structure, in which GPs take a share of the profits realized from their portfolios. However, managers of these funds must balance a more complex set of objectives: achieving social and/or environmental impact in addition to generating financial returns. Given this complexity, how can investors ensure that impact objectives are appropriately weighted in investment decisions?

Some impact investors are attempting to address this challenge by tying a portion of GP compensation to social and environmental performance. An impact-based incentive structure raises the GP's financial stake in the non-financial performance of their funds.

As the impact investing industry develops, the Global Impact Investing Network (GIIN) is observing growing interest in impact-based incentive structures—both how they can be designed and how they work in practice. The concept of incorporating non-financial performance in GP compensation is relatively novel. This issue brief draws from early examples to explore key considerations in putting together such structures and presents a framework to guide prioritization in their design.

In exploring this topic, the GIIN hopes to spark further dialogue on opportunities and challenges around impact-based incentive structures. The GIIN does not advocate the use of such structures, nor does it endorse a specific approach. As the industry evolves, it must remain accountable to social and environmental goals. For impact investment funds, these incentive structures may complement rigorous measurement and assessment of social and environmental performance to increase accountability and transparency around the achievement of their objectives.

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1 In the context of private equity funds, which are commonly structured in the legal form of a limited partnership, a general partner, or GP, has unlimited liability for debts and obligations in the partnership and holds management responsibilities. A GP is typically the firm managing the fund. A limited partner, or LP, is a partner that has limited liability for debts and obligations according to the share of ownership. LPs are individual or institutional investors that contribute capital to private equity funds.
Research Methodology

This issue brief is based on research conducted through more than a dozen interviews with members of the GIIN Investors’ Council and other leading impact investors who are knowledgeable about the topic. Several of those interviewed have implemented impact-based incentive structures as GPs or have participated as LPs in funds with such practices. This research identified several funds with management compensation structures that incorporate social and environmental performance, and three distinct approaches are profiled and referenced throughout this paper. The three entities whose impact-based incentive structures are highlighted are Aureos Capital’s Africa Health Fund (Aureos), Core Innovation Capital (Core), and UBS.

Key Considerations for Designing Impact-Based Incentive Structures

Early examples suggest that there are a variety of ways to design impact-based incentive structures for GPs, and that each approach prioritizes specific financial and impact objectives. The funds featured in this discussion have the traditional private equity or fund of funds compensation model as the basis for their impact-based incentive structures. That is, the GP is paid an annual salary, an annual bonus, and a carry, or a set percentage of the financial returns that result from an investment’s liquidation. Those considering impact-based incentive structures in the context of these two types of funds can use the following key questions to broadly determine a compensation design that aligns with their financial and impact objectives:

- Should incentives address the portfolio’s short-term or long-term impact performance, or both?
- Should incentives penalize and/or reward GPs for the extent to which impact targets are met?
- What is the appropriate amount of compensation linked directly to social and environmental performance? What should be done with any monetary proceeds not distributed to GPs due to inability to meet impact targets?
- How and by whom are social and environmental performance metrics and targets defined?
- How can social and environmental performance be effectively monitored?

The profiles on pages 3-5 outline the impact-based incentive structures employed by Aureos Capital’s Africa Health Fund, Core Innovation Capital, and UBS. The discussion that follows explores the key considerations highlighted above to help guide thinking about the design of impact-based incentive structures. These three examples are referenced throughout the discussion to illustrate ways these considerations can be addressed.

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2 The Investors’ Council is the membership program of the GIIN. It serves as a platform for leading, active impact investors to share experiences, learn about emerging sectors, explore opportunities for collaboration, and contribute to industry development. Members of the Investors’ Council include family offices, diversified financial institutions, fund managers, specialized banks, institutional investors, foundations, and development finance institutions.

3 For a complete list of individuals who contributed their perspectives to this issue brief, see page 11.
Aureos Capital’s Africa Health Fund

IMPACT-BASED INCENTIVE STRUCTURE

RATIONALE
Performance towards the development objective of the Fund is included in the GP compensation structure because the fund manager believes that socially-motivated business practices enhance financial returns, while also adding positive value to society.

IMPACT ASSESSMENT
An annual impact assessment is conducted on the overall portfolio to ascertain the proportion of total clients served that comes from the targeted BoP population, with periodic in-depth reviews by a third party. Three development targets are set according to the percentage of BoP clients served by portfolio companies:

- **Impact target A**: 50% of people served have an average annual household income of less than $3,000 PPP
- **Impact target B**: 70% of people served have an average annual household income of less than $3,000 PPP
- **Impact target C**: 15% of people served have an average annual household income of less than $1,000 PPP

COMPENSATION STRUCTURE
The base carry is 15% for achieving the financial hurdle** and is adjusted upward according to the achievement of one or more of the three impact targets. Assuming that the financial hurdle is met:

- **Base carry for achieving financial hurdle**: 15% of people served have an average annual household income of less than $3,000 PPP
- **Target A is met**: 5% of people served have an average annual household income of less than $3,000 PPP
- **Target B is also met**: 10% of people served have an average annual household income of less than $3,000 PPP

**Final GP carry**

EXAMPLE
If the financial hurdle is met and 80% of all clients served by the portfolio companies earn an average annual household income of less than $3,000 PPP, then the GP carry is:

\[
15\% + 5\% + 10\% = 30\%
\]

IMPACT MEASUREMENT AND REPORTING PROCESS
Some of the LPs have contributed to a technical assistance (TA) facility which exists alongside the fund. This TA facility is used to pay a third party to measure and validate the social impact achieved, as well as to enhance business development services in portfolio companies and facilitate knowledge sharing across similar emerging markets where BoP health models have been successful. In addition, in the lifetime of the Fund, Aureos will twice release a publicly-available health development report to share lessons learned, innovations in inclusive business models, and success stories.

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**Purchasing Power Parities (PPPs) are currency conversion rates that both convert to a common currency and equalize the purchasing power of different currencies. They eliminate the effect of differences in price levels between countries. Source: www.oecd.org/std/ppp**

**Hurdle rate is the threshold of financial return paid to LPs before any carry is paid to the GPs.**
Core Innovation Capital

**IMPACT-BASED INCENTIVE STRUCTURE**

**RATIONALE**
The fund created a direct link between an Impact Score (see “Impact Assessment” below) and GP financial compensation to provide a clear incentive for the GP to manage the portfolio toward high financial and social performance.

**IMPACT ASSESSMENT**
An Impact Audit Committee, comprised of three members (a representative from the Center for Financial Services Innovation and two external members with experience in impact investing at the national level), reviews the social performance of investments and the GP’s actions in supporting intended social outcomes to determine an Impact Score. The Impact Score is composed of two parts: an industry-based score and a portfolio-based score, which account for 10% and 90% of the impact assessment, respectively. The industry-based component is a qualitative evaluation of the GP’s leadership and influence in the impact investing field, and factors in activities such as speaking engagements at impact investing events. The portfolio-based component looks at the fund’s investments individually and in aggregate, and weighs factors such as ability of portfolio companies to meet impact objectives, quality of the systems used to evaluate impact, and performance reporting compliance.

**COMPENSATION STRUCTURE**
An annual bonus, derived from a 2% management fee, is paid to the GP in direct proportion to the percentage of the total Impact Score achieved.

The 20% carry is comprised of two components: 90% of the carry (i.e. 18% of the portfolio’s total profit) is tied to financial performance, and the remaining 10% (i.e. 2% of the portfolio’s total profit) is paid to the GP in direct proportion to the percentage of the total Impact Score achieved.

**EXAMPLE**
If the GP achieves an annual Impact Score of 75%, then 75% of the maximum annual bonus is awarded.

If a liquidation event occurs, then the GP carry is calculated by first taking the average of the yearly Impact Scores for the portfolio. The average Impact Score is then multiplied by the portion of carry tied to impact, or 10% of the 20% base carry, which is added to the portion of the base carry that is tied to financial performance. For example, if at the time of a liquidation event, the average Impact Score for the portfolio is 70%, then:

<table>
<thead>
<tr>
<th>70%</th>
<th>x</th>
<th>[10% x 20%]</th>
<th>+</th>
<th>[90% x 20%]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Impact Score of portfolio at time of liquidation event</td>
<td>Portion of carry tied to impact</td>
<td>Final GP carry for year of liquidation event</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.70</td>
<td>0.10</td>
<td>0.18</td>
<td>0.194</td>
<td></td>
</tr>
</tbody>
</table>

**IMPACT MEASUREMENT AND REPORTING PROCESS**
The GP determines portfolio-level impact metrics during due diligence and in investment documents between the fund and each portfolio company. All portfolio companies report both short- and long-term metrics. The common metric tracked across all portfolio companies is the number of low- and moderate-income people served. The Impact Audit Committee determines the annual Impact Score. The share of compensation that is not awarded to the GP as a result of not meeting impact targets is distributed to a nonprofit organization selected by the GP. This mechanism effectively serves as an impact hedge, ensuring that any amount of unallocated incentive is used toward achieving social impact.
**RATIONALITY**
Impact incentives are incorporated in GP compensation to ensure that there is no mission drift away from social and environmental goals.

**IMPACT ASSESSMENT**
An Impact Coefficient is used to represent the percentage of social benchmarks that are met by the fund. The social benchmarks are outlined in an annual impact report and can be adjusted on a year-to-year basis when appropriate and justified. The Impact Coefficient, expressed as a number between 0 and 1, is derived based on a balanced weighting of five components:

1. **Investment Policy Targets, which include:**
   - Countries in which investee companies operate have a lower GDP per capita than the benchmark set in the investment policy
   - A minimum number of countries qualify as Least Developed Countries (LDCs)†
   - Exposure to nascent sectors with high social impact and low expected financial returns
2. **Implementation of ESG policy, which includes:**
   - A specified target number of funds have a designated ESG officer on the management team
   - A specified target number of funds provide ESG training to investment staff
   - A specified target number of funds have established protocols to follow up with any serious ESG incidents involving portfolio companies
3. **Employment Growth:** Average employment growth within investee companies exceeds a benchmark by a specified percentage. The benchmark is calculated as the historical GDP growth of the countries in which the companies operate.
4. **Sector-Specific Indicators:** UBS portfolio allocation meets pre-determined sector-specific impact metrics each year. Metrics are aligned with the Impact Reporting and Investment Standards (IRIS)†† where appropriate.
5. **Quality of Reporting:** Effort is made to continually improve the quality of impact reporting.

**COMPENSATION STRUCTURE**
The carry paid to the GP is capped at 10% and is awarded in direct proportion to the Impact Coefficient at the portfolio level. This carry is applied to the financial return achieved, which is also capped at a specified ceiling.

**EXAMPLE**
If the Impact Coefficient is 0.8, then the GP carry is:

\[
0.8 \times 10\% = 8\%
\]

**IMPACT MEASUREMENT AND REPORTING PROCESS**
The GP will report performance data in an annual impact measurement report. An independent Social Impact Committee comprised of an impact expert and two UBS team members will work with the GP and an external third-party assurance auditor each year to determine the validity of these data. The goal is to verify the impact data on 10% to 20% of the companies in the fund of funds’ portfolio by the end of the fund’s term. An Impact Coefficient is then determined by the independent assurance auditor at the end of life of the fund of funds.

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† Least Developed Countries (LDCs) constitute a group of countries that are characterized by extreme low level of socio-economic developments as defined by the United Nations. See http://www.un.org/special-rep/ohrlls/ldc/ldc%20criteria.htm for criteria and a list of current LDCs.

†† The Impact Reporting and Investment Standards (IRIS) is a common language for measuring and tracking the social, environmental, and financial performance of mission-driven organizations. See www.iris.thegiin.org.
Discussion

The impact-based incentive structures of Aureos Capital’s Africa Health Fund, Core Innovation Capital, and UBS are referenced in the following discussion to illustrate ways of addressing key considerations in linking GP compensation to impact.

ADDRESSING SHORT- AND LONG-TERM SOCIAL AND ENVIRONMENTAL PERFORMANCE

The two types of GP compensation that can be linked to social and environmental performance are the bonus and the carry. At a basic level, the bonus is tied to short-term performance, while the carry is determined by performance over a longer time frame.

Aureos and UBS both take into account the percentage of impact performance targets achieved over time when determining the total carry for their GPs. For Aureos Capital’s Africa Health Fund, the GP receives the base carry when a pre-determined financial hurdle is achieved, and earns a higher carry when impact targets are met. Similarly, at UBS, the GP needs to meet a financial hurdle requirement before becoming eligible for any carry, which is based entirely on the portfolio’s impact performance.

In contrast, Core looks for investment opportunities with the ability to deliver both short- and long-term value for low-income consumers. Therefore, Core has made a conscious decision to align both the annual bonus and the carry of its GP to impact performance.

A key consideration for determining whether to tie incentives to short-term and/or long-term social and environmental performance is the extent to which a portfolio’s expected financial returns may contribute to the bonus and carry. For a fund with relatively low expected financial returns at the time of the fund’s liquidation, an incentive tied to the bonus, rather than the carry, may be more effective as it would represent a meaningful contribution to the GP’s overall pay. Conversely, if a fund anticipates high profits when its investments liquidate, then the carry would create a stronger financial incentive for the GP.

PENALIZING AND/OR REWARDING GPs FOR SOCIAL AND ENVIRONMENTAL PERFORMANCE

An impact-based incentive structure can be designed to penalize GPs for subpar impact by reducing compensation and/or reward outstanding impact by increasing compensation above conventional levels.

According to Aureos’ incentive structure, a minimum impact target must be met in order for the GP to receive a 20% carry, the standard in private equity funds. If the GP meets a predetermined financial hurdle but does not achieve any impact target, a base carry of 15% will be awarded. If the first impact performance target is met, the GP carry increases 5% to a total of 20%. The GP can earn a further 10%—for a total carry of 30%—if one of two additional impact targets is met.

The GPs of Core and UBS are not financially rewarded for outperforming impact objectives, but can lose some or all of their incentive pay if these objectives are not met. The annual bonus available to Core’s GP is reduced if short-term impact objectives are not met. At both Core and UBS, the GP carry can decline if long-term impact objectives are not achieved. The worst-case scenario of no positive impact will result in an 18% carry for Core’s GP (assuming...
the financial hurdle is met), and a 0% carry for the GP at UBS. The best-case scenario occurs when the GP achieves maximum impact and earns the highest carry available based on both financial and impact performance, yielding a 20% carry at Core, and a 10% carry at UBS.⁴

**DETERMINING SIZE OF INCENTIVE AND UTILIZATION OF UNEARNED CAPITAL**

Varying proportions of GP compensation can be tied to social and environmental performance.

Core ties 100% of its GP bonus and 10% of the base carry of 20% (i.e. 2% of the portfolio’s profit) to impact, while at UBS, 100% of the 10% carry is aligned with social performance (i.e. 10% of the portfolio’s profit). Aureos’ GP receives a base carry of 15% if the pre-determined financial hurdle is met and can earn an additional impact-based incentive that represents between 33% and 100% of the base carry (i.e. between 5% and 15% of the portfolio’s profit.)

If impact targets or objectives are not met, some money in the pool of available compensation is forfeited. This research has identified two options for handling the forfeited capital: return it to LPs or donate it to an independent third-party entity that supports a social or environmental objective similar to that of the fund. Core, for instance, adopts the latter approach and distributes the portion of the impact-based incentive that is not awarded internally to a nonprofit organization selected by the GP.

**DEFINING SOCIAL AND ENVIRONMENTAL PERFORMANCE**

At the heart of impact-based incentive structures are metrics and targets against which a portfolio’s social and environmental performance can be measured and the GP compensation determined. Clear articulation of impact definition and measurement helps to ensure the credibility of impact investments, support increased transparency for stakeholders, improve business operations of portfolio companies, and enable more effective portfolio management.

Various stakeholders can be responsible for determining the metrics and targets used in impact-based incentive structures. For example, at Aureos, the fund’s impact targets are determined through collaboration between the GP and LPs, which come to an agreement on impact goals, approaches to performance measurement, and incentives. At UBS, a Social Impact Committee comprised of an independent impact expert from the advisory board of the fund of funds and two UBS staff members works with the GP to determine the metrics to which the GP is held accountable. When there is uncertainty, the Social Impact Committee alone will make the final decision. Similarly, Core’s GP determines the metrics for each portfolio company during due diligence, which are then approved by an internal Impact Audit Committee.

The social and environmental targets tied to GP compensation should be clearly defined and tracked. As the following examples show, these targets can be qualitative and quantitative.

⁴ UBS’ impact-based incentive structure is an approach for a fund of funds, and 10% is a typical carry for funds of funds.
Aureos uses a quantitative metric as a basis for determining GP incentives. In aggregate, across the fund’s portfolio, at least 50% of the clients served by investee companies must come from the base of the pyramid (BoP) in order for the GP to earn the 5% impact-related carry in addition to the 15% base carry. BoP is defined by Aureos as the population of individuals earning an average annual household income of less than $3,000 PPP. The GP can earn a carry greater than 20% by meeting at least one of two additional targets: 1) the percentage of BoP clients served by the portfolio is at least 70%, or 2) more than 15% of individuals served by the portfolio are at the “bottom of the BoP,” defined as those with an average annual household income of less than $1,000 PPP.

At Core, GP compensation is determined using an Impact Score, which measures social performance resulting from both industry- and portfolio-related activities, which account for 10% and 90% of the impact assessment, respectively. Determined by an Impact Audit Committee, the industry-level assessment consists of qualitative indicators that measure the GP’s leadership and best practices in impact investing. The portfolio-based assessment looks at the investments both individually and in aggregate and weighs qualitative and quantitative indicators of social performance. Specific short- and long-term social metrics are identified for each portfolio company during due diligence and then incorporated in investment memos. Qualitative metrics include impact achieved, leadership, and systems used for impact monitoring and evaluation. A common quantitative metric applied across all portfolio companies is the number of low- and moderate-income people served. The Impact Audit Committee’s annual impact audit determines if the resulting impact attained is below, at, or above expectations, and also evaluates and updates impact goals and metrics. The resulting Impact Score forms the basis for GP compensation.

UBS determines an Impact Coefficient for the entire portfolio based on the following five criteria: 1) investment policy targets; 2) implementation of ESG policy; 3) employment growth; 4) sector-specific indicators; and 5) quality of reporting. The GP is thus incentivized to: meet targets set in the investment policy, such as investing in least developed countries; follow an effective ESG protocol; strive for high employment growth in portfolio companies; achieve sector-specific metrics; and continually improve reporting efforts.

MONITORING SOCIAL AND ENVIRONMENTAL PERFORMANCE

A central challenge facing the impact investing industry is effective monitoring of social and environmental performance. Ensuring the integrity and quality of reported data is crucial when financial compensation is tied to performance. Aureos, Core, and UBS employ different approaches to address this challenge.

For Aureos, some of the LPs have contributed money to a technical assistance facility that is used to pay independent third parties for performance reporting and auditing. The fund manager also expends its own resources on monitoring and measurement of impact performance.
Core’s GP pays for the reporting out of the management fee, and the Impact Audit Committee performs the audit.

UBS relies on a third-party assurance auditor to check impact metrics and other required information reported by fund managers.

Looking Ahead

Impact-based incentive structures, when designed and implemented appropriately, could be an effective tool in motivating GPs to achieve the stated social and environmental impact of their funds. The uptake of these approaches by the broader impact investing community will depend on various factors, including:

- **Demand from LPs.** Observations to date suggest that demand for impact-based incentive structures by LPs is mixed. Some are in favor of this practice precisely because they want to ensure that their impact investments deliver the desired impact. Others who are experimenting with impact investment funds as a novel approach have reservations, viewing this new practice as adding unnecessary complexity. Another view contends that it is difficult to identify and measure the most appropriate impact targets at the time of initial investment, concluding that it is unrealistic to reward GPs according to impact-based incentives.

- **Interest or willingness among GPs to link part of their financial stake to social and environmental performance.** GPs who consider impact-based incentives are likely to view them as a compelling way to signal their commitment to impact, confidence in their abilities, and/or alignment with LPs’ interests. Impact assessment and auditing embedded within impact-based incentive structures could also be viewed as a mechanism for more robust portfolio management.

The structure of impact-based incentives should be carefully crafted to avoid unintended consequences. Misaligned incentives can pose financial implications for both GPs and LPs, challenge the sustainability and operations of portfolio companies, and undermine the effectiveness or ability of impact investments to address social and environmental challenges.

Implementing impact-based incentive structures requires stakeholders to weigh many different factors. For early implementers like those highlighted in this paper, it has been important that the systems and processes created are relatively simple and manageable. The examples provided by Aureos, Core, and UBS point to early lessons for further consideration, including the following:

- **Governance by independent bodies, for both impact assessment and the resulting compensation, could help ensure transparency and integrity.**

- **Financial returns need to be compelling and liquidation events need to become common practice within impact investing in order for incentives tied to the carry to be a meaningful lever.**
Opportunities exist for GPs, LPs, and portfolio companies to explore how the costs, resources, and processes required for social and environmental performance measurement can be managed properly without creating an excessive burden on any one party.

Impact must be clearly defined, carefully measured, and reported with credible metrics.

Aureos Capital’s Africa Health Fund, Core Innovation Capital, and UBS are among the pioneers in designing impact-based incentive structures. Each has created unique structures that incorporate social and environmental performance metrics and targets relevant to their stakeholders. The progress of these and other approaches, combined with additional experimentation in design, will yield valuable insights for improving the social, environmental, and financial performance of impact investments.
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Global Impact Investing Network

The Global Impact Investing Network (GIIN) is a not-for-profit organization dedicated to increasing the scale and effectiveness of impact investing. The GIIN builds critical infrastructure and supports activities, education, and research that help accelerate the development of a coherent impact investing industry. The GIIN’s programs center around four key initiatives. The GIIN Investors’ Council is a diverse, global membership group comprised of leading impact investors with a goal of enabling rigorous impact investments, enhanced social and environmental performance, and deployment of private investment capital to address social and environmental challenges. The Terraqua Working Group within the Investors’ Council is focused on impact investing in sustainable agriculture in sub-Saharan Africa. The GIIN’s Impact Reporting and Investment Standards (IRIS) is a common language for measuring and tracking the social, environmental, and financial performance of mission-driven organizations. The GIIN’s ImpactBase is an online global directory of impact investment funds active in the impact investing industry, created to reduce search costs and bring order to the fragmented marketplace. The GIIN Outreach initiative elevates the profile of impact investing by highlighting industry progress and best practices.

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