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PERSPECTIVE

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Impact fund formation growing rapidly

By Sara L. Terheggen

Impact funds are similar in structure to a typical private equity fund, but the purpose is focused towards environmental, social and/or governance (ESG) factors. The frequency in the number of impact funds being formed is growing significantly. Two trends are happening simultaneously in this space. Availability of capital earmarked for some type of impact return is growing and demand from investors to document actual impact is increasing. As a result, the focus has turned quite significantly to determining how best to assess value. In a traditional private equity fund, assessing value is easy because it is tied directly to financial performance. But in an impact fund, value is construed more broadly and objectives related to ESG goals are often difficult to assess.

While there have been several articles surrounding this topic, the procedural framework, measurement and reporting methodologies relating to ESG factors especially in the private fund space are still at their preliminary stages and often presuppose that assessment can be layered on as an afterthought. For real assessment of impact to happen, there needs to be a strong focus on establishing a system for assessing value that ultimately begins with establishing the structural elements of the fund first. These elements fall into three categories: purpose, governance and compensation. By first considering and aligning these elements, a sponsor can establish a strategic framework from which to develop an assessment plan to determine impact performance.

Purpose

Whether a sponsor intends to raise a fund focused on climate change or increasing access to medical care for underserved populations, purpose lays the critical foundation from which value will be created and ultimately measured. For impact funds, purpose is a critical differentiator. It is the basic

objective for any impact fund. When looking at fund purpose, it is important to consider the following:

Breadth. Purpose should be broad enough to allow for strategic changes in direction but specific enough to provide the basis for developing an assessment plan.

Type of investor. Depending on the purpose of the impact fund, not all investors will be the right type of investors. Purpose helps guide the selection of the right mix of high net worth individuals, foundations, endowments and/or traditional institutional investors.

Alignment. Consider how to monitor deviation from purpose. It is easy to find a good investment that may provide positive financial returns but strays from the fund's purpose. This is where strong governance, discussed further below, can be helpful in keeping true to purpose.

Governance

In the context of an impact fund, governance goes beyond simply establishing an investor advisory board and requires a real focus on determining how to structure longterm alignment of interests between sponsor and investors to best generate impact value. Some of the key elements include:

Fund term. In general, impact funds employ a longer term than traditional private equity funds since investments in the impact space can require a longer period of time to generate profitability. Fund terms often range from 15 to 20 years (compared to 10 years). Some even opt for an evergreen structure whereby there is no limit set on fund term.

Accountability. This involves creating the right set of checks and balances to ensure an impact fund's purpose results in profitability. This should include considering governance mechanisms at three different levels: sponsor, investor and portfolio company. Sponsors must consider the types of governing bodies, protective provisions and

mechanisms that will create alignment of interests.

Liquidity. Given the longer fund term, sponsors need to consider investor flexibility in order to make the impact fund vehicle attractive to the average investor. Structuring options can be varied depending on the fund's purpose but may include robust current income distributions, robust transfer rights, redemption rights or some combination thereof.

Compensation

Providing the right incentives for the sponsor is a key component to establishing a structure that rewards performance on impact goals, in addition to financial goals. Carried interest and management fee are the two main fee streams typical in a private equity fund context and these are often modified for impact funds to better encourage sponsors to seek out impact.

Carried interest. Most impact funds align sponsor compensation with impact objectives. This can be done through revising the traditional 20 percent carry percentage or providing some type of bonus compensation. Carry can be structured such that a small percentage of the carry is allocated towards obtaining impact goals or alternatively structured to take carry away if such objectives are not met.

Management fee. Most impact funds implement a budget system instead of requesting a fee equal to a percentage of assets under management as is typical in a traditional private equity fund. The budget allows for better transparency and assurance from the sponsor on how funds are allocated. Given the longer term of an impact fund, investors find the budget approach to be more palatable in aligning interests. For implementing compensation, the critical aspect relates back to governance. Most impact funds will provide for some type of investor oversight when determining whether impact objectives have been met which serves to further align purpose,

governance and compensation.

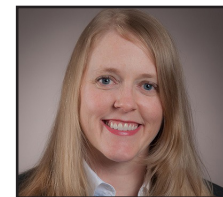
Performance

In the impact fund space, profitability can be measured in two ways: financial goals and impact goals. Private equity funds know how to measure financial goals but measuring impact poses a new and unique set of challenges. Ideally, if purpose is established and that purpose and governance are aligned with compensation, it is assumed that impact will follow. Fund sponsors, however, need to establish an assessment plan that incorporates appropriate impact targets and metrics. This plan should be established at the outset and careful consideration given to the plan at all stages of investment, including the investment decision, monitoring and exit. Impact targets and metrics should also be specific to investment areas. Governance can play a critical role in providing the necessary accountability to ensuring purpose is achieved and compensation of the sponsor helps to provide proper alignment of interests in the system.

Conclusion

Measurement of impact value is a difficult undertaking and cannot be an afterthought. As a starting point, fund sponsors need to consider the structural elements of their fund with a goal of aligning purpose, governance and compensation to lead to better performance. This strategic framework is a critical first step in establishing a fund that has a system for assessing impact and determining value.

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