Contracts With Benefits: The Implementation of Impact Investing

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

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Setting the Scene

- **We've witnessed an amazing rise in interest, capital & opportunities for SRI/ESG/Impact Investing**
  - Signatories to the UN PRI: $70 trillion; Global Impact Investor Network (GIIN): $22 billion; SRI/ESG/Impact in the US: $10 trillion; thousands of funds, thousands of students, etc.
- **However, challenges abound**
  - Among others, it is difficult to define goals, understand and model preferences and measure performance; concerns about greenwashing
  - How is impact different? The same?
- **How are impact goals reflected in covenants and governance?**
  - Contracts define rights, responsibilities, limitations, etc.
    - Reflecting and refining incentives and priorities and deal with agency problems, moral hazard, etc.
  - Setting: contracts from "impact investing" funds
    - PE & VC funds with a social benefit goal *and* a financial goal
    - Contracts forward with Portfolio Companies (PCs) and backward with Limited Partners (LPs)
- Continues a line of research we started several years ago…

Setting the Scene

- Our paper analyzes **how impact goals are reflected in the contracts** between General Partners (GPs: managers) and Limited Partners (LPs: investors) for private funds (PE/VC) with an impact focus. Additionally, how impact goals are reflected in contracts between GPs and their PCs
- We identified two types of impact contract provisions:
  - ***Aspirational*** terms: high level, describe intended impact. For example, "this fund aims to reduce carbon emissions"
  - ***Operational*** terms specify how goals are being implemented by the fund – there's something actionable and enforceable. For example, impact is incorporated in the due diligence process, there's a commitment to ESG standards, and so on

Setting the Scene

- We also identified two types of impact fund
  - ***Market Rate Seeking (MRS)*** funds seek to generate social impact as well as a risk/return comparable with non-impact funds in their asset sub-class
  - ***Non Market Rate Seeking (NMRS)*** funds (and their investors) are willing to accept a cost (lower expected return) associated with the social return they seek

Major Findings

- **There is a large overlap in the "DNA" of Impact with non-Impact settings**
- **There are important differences apropos of the addition of impact considerations**
  - Agency issues, incentive differences and preferences related to impact appear to be addressed, with some expected (and some unexpected) dispersion
- **Impact is operationalized broadly**
  - **We interpret these to repudiate the greenwashing hypothesis.**
- **There are many subtleties in the contracts.**

Major Findings: Some Subtleties

Companies held by NMRS funds are less likely to address impact directly in their contracts – this difference is statistically significant

— Though seemingly counterintuitive, this might reflect mostly the type of company held by NMRS funds: most common industry in this group is agribusiness, whereas for companies held by MRS funds, most common industry is microfinance

— It could also be a reflection of less need to contract directly if there is less tension between goals. That is, if you're pulling strongly in the financial direction as well as the impact direction, maybe you need to be especially careful to protect your impact goal with contract terms, where if you have less of a tension because you have less of that financial emphasis, then there's less imperative to contract

Major Findings: Some Subtleties

There exists a positive and statistically significant relationship between company-level operational impact and fund-level operational impact

- — GPs routinely (but not always) write impact terms into their contracts with their PCs
- — Operationalizing at the fund level (via contracts with the LPs) seems to flow through to the PC level (especially for MRS funds)
- — Thus the LPs’ interest in generating social return is imposed on the PCs

From the Survey a Categorical Question

What is the statement that best describes the fund's financial return goals?

– Targeting competitive, market rate returns
– Targeting below market, but close to market returns
– Targeting below market, close to capital preservation returns
– Not Applicable (Explain)

Our Two Angles

1. Market Rate Seeking (MRS) impact funds v. non-impact funds
   - Both seek competitive financial returns, but only the former also seek particular social impact
   - Rely on rich literature on non-impact PE and VC contracting – Gompers & Lerner (1996, 1999); Kaplan & Stromberg (2003); Metrick & Yasuda (2010); Gompers, Kaplan & Mukharlyamov (2016); Gompers, Gornall, Kaplan & Strebulaev (2016)

2. Market Rate Seeking (MRS) vs. Non-Market Rate Seeking (NMRS) impact funds
   - Both seek social impact, but former have relatively more emphasis on financial goal

How Might Contracts Incorporate Impact Goals?

1. Direct contracting
   - Set expectations, differentiate fund as investment product
   - Create enforceable contract rights
   - Address agency problems – provided that monitoring costs are low, & desired outcomes measurable
2. No explicit contracting
   - "Greenwashing"
   - Not contracting can be optimal when task is difficult to measure (Holmstrom & Milgrom 1991)
   - Encourage parties to comply with spirit rather than letter of the law (Hart & Moore 2008)
   - Impact sufficiently embedded – direct contracting could then be redundant
     - *Great Expectations* (WSII paper)
3. Indirect Contracting

The Data

- Wharton Social Impact Initiative (WSII) outreach to impact funds
  - Compiled database from primary research and partner lists (B Lab, EMPEA, Anthos …)
- For this paper
  - 202 documents
    - 106 GP-LP documents representing 54 funds
    - 96 GP-PC documents representing 92 portfolio companies
  - 29 MRS, 14 NMRS funds
  - We score contracts on different dimensions
    - Impact, return protection, controls…
  - The funds are primarily small, early-stage yet are invested globally

The Data: Contract Coding

Table 5: Contract Dimensions

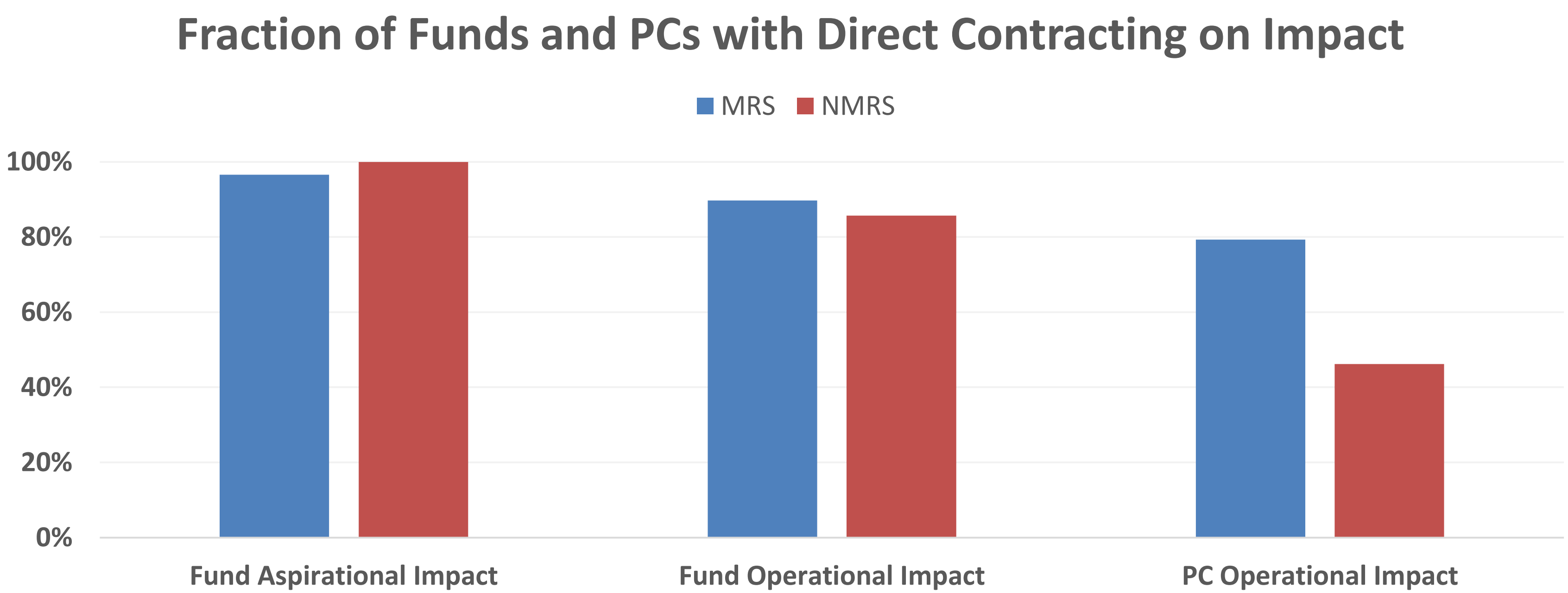
GP-LP contract dimensions	
1- Investor return protection	Direct contract rights that protect investors' investment in the fund. *E.g. investor call/put options, tag along/drag along rights, liquidation cash flow rights.*
2- Indirect investor control	Indirect contract rights that may protect investors' investment. *E.g. information rights, presence and role of advisory committee.*
3- Limits to manager discretion	The discretion afforded to fund managers under the terms of the agreement. Made up of two sub-categories: asset restrictions, and prohibitions. *E.g. investment cap in PCs, sectors, regions; prohibition on investment in harmful substances, prohibition on hostile transactions.*
4- Manager restrictions	Restrictions imposed on managers. *E.g. fiduciary duty, ability to reinvest funds, restriction on manager's outside activities.*
5- Aspirational impact	Terms which describe intended impact. *E.g. social or environmental impact addressed, negative impact prohibited.*
6- Operational impact	Terms which incorporate impact goals into contract in actionable way. *E.g. commitment to ESG standards, compensation tied to impact.*
GP-PC contract dimensions	
1- Exit control	Fund's exit paths from the investment in the portfolio company. *E.g. put option in PC securities, tag along/drag along rights, termination rights.*
2- Investment protection	Fund's direct contract rights to protect its investment in the portfolio company. *E.g. ROFR in other PC securities, preemptive/anti-dilution rights, liquidation cash flow rights.*
3- Governance	Fund's ability to participate in the going operation of a portfolio company. *E.g. ownership, board seats, veto rights.*
4- Information rights	Fund information rights. This is a possible subset of governance rights. *E.g. quarterly or annual information rights, form of information shared.*
5- Fund restrictions	Restrictions imposed on fund. *E.g. ROFR on fund securities, non-compete with PC.*
6- Operational impact	Terms which incorporate impact goals into contract in actionable way. *E.g. mission lock, impact measurement.*

The Data: Example

Table 12: GP-PC Contracts

	Non-impact		Impact		
	Comparison point	Non-impact funds	MRS funds	NMRS funds	*Difference t-statistic*
Panel A: Investment protection					
Investment protection – total score			*35.4*	*36.6*	*-0.254*
Anti-dilution of fund investment	KS	95%	83%	58%	*2.515***
Full ratchet preemption	KS	22%	17%	27%	*-1.015*
Weighted average preemption	KS	78%	12%	8%	*0.594*
Founder/entrepreneur non-compete	KS	70%	52%	54%	*-0.178*
Fund liquidation rights	KS	71%	38%	81%	*-3.907****
Panel B: Governance					
Governance – total score			*32.6*	*25.2*	*3.032****
Investor board seats guaranteed	KS	41%	93%	69%	*3.01****
Number of guaranteed seat?	GKM	2.80	1.31	1.67	
PC board size	GKM	5-7 members	4.07	3.88	*0.165*
	KS	6 members			
Investor majority control	KS	25.4%	0%	0%	*n/a*
Investor min. voting %	KS	53.6%	31%	20%	*4.474****
Panel C: Exit					
Exit control – total score			*32.7*	*25.1*	*1.968**
Fund put/redemption right	KS	79%	62%	50%	*1.031*
	S	43.32%			
Registration rights	S	90%	50%	54%	*-0.322*

Most Funds Have *Some* Direct Contracting on Impact

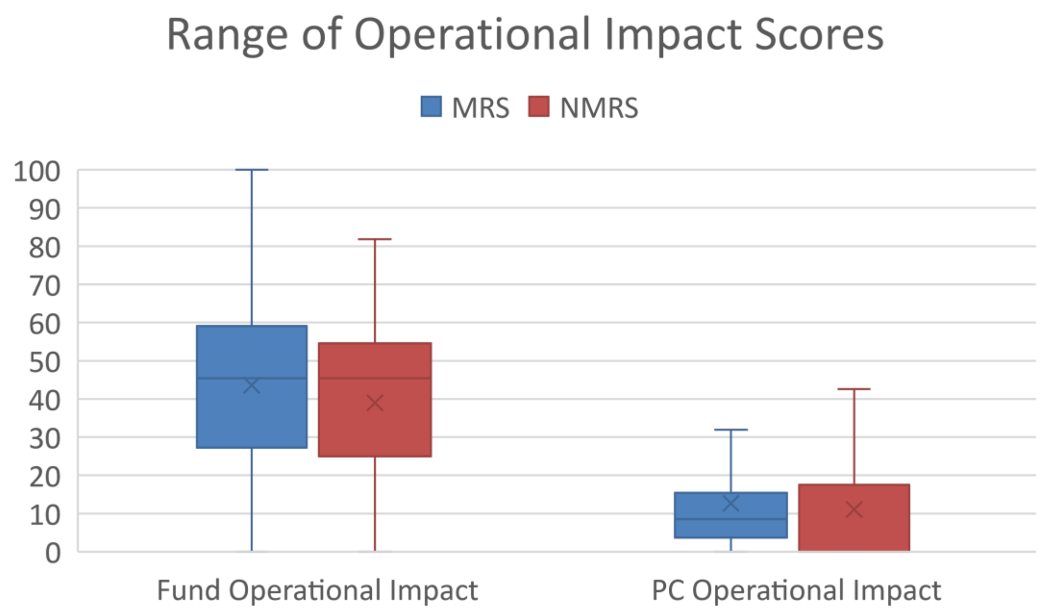


- MRS and NMRS both operationalize, at the fund level
- In contracts with portfolio companies, less need to operationalize for NMRS funds?

Extent of Operationalizing Varies Widely

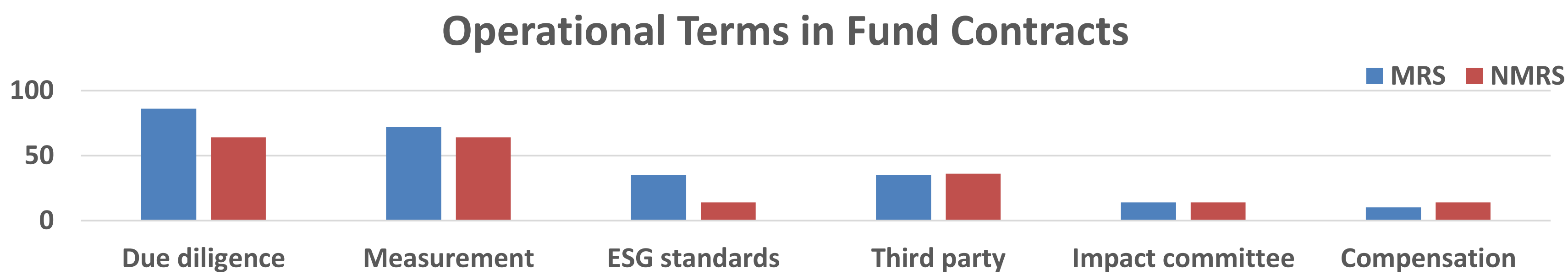
Operational impact score

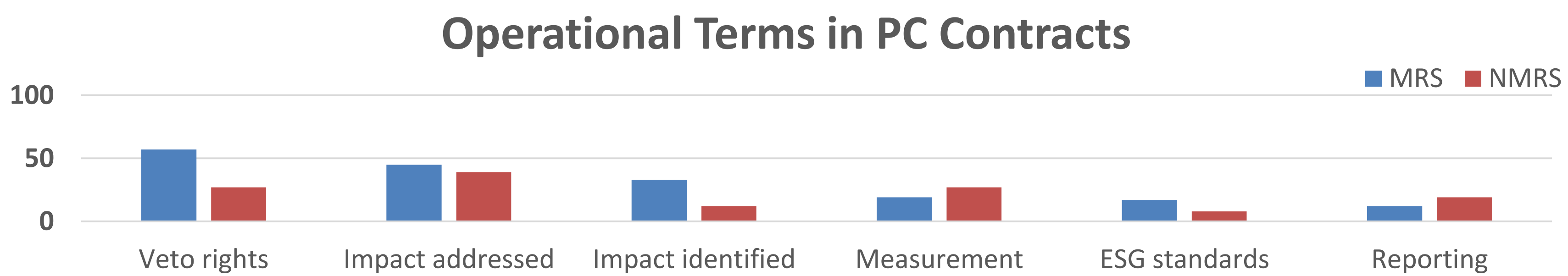
- ESG standards
- Due diligence
- Measurement
- Reporting
- Impact committee
- Prohibited activities
- Mission lock



- Funds vary widely in extent of direct contracting on impact
- Operational scores are higher at fund-level than PC-level, in both MRS and NMRS

Funds Differ In How They Operationalize





- MRS funds emphasize due diligence, ESG standards, veto rights
- NMRS funds emphasize measurement, reporting

Operational Impact Is Correlated Across PC and Fund Levels

	PC Operational Impact		
Fund terms	*All*	*MRS*	*NMRS*
Investor return protection	-0.100 (0.0758)	0.005 (0.084)	-0.486 (0.4401)
Indirect investor control	**0.257***** (0.0868)	**0.659***** (0.1065)	0.001 (0.1465)
Limits to manager discretion	**0.315**** (0.1468)	**0.780***** (0.1529)	-0.029 (0.4802)
Manager restrictions	0.012 (0.0591)	**0.216***** (0.0738)	-0.070 (0.1261)
Aspirational impact	**-0.166*** (0.0938)	0.2433 (0.162)	0.114 (0.4608)
Operational Impact	**0.214***** (0.0673)	**0.377***** (0.0738)	-0.164 (0.1437)

- Operational terms at fund level flow through to PC level
- Indirect investor control and limits to manager discretion also correlated with operational terms in PCs

Other Findings

1. For Governance (Advisory and Oversight)
   - Advisory committees, guaranteed board seats, percentage of board guaranteed
   - For both MRS and NMRS, fund level scores higher than PC-level
     - **But at a univariate level, governance looks stronger for MRS funds**
   - Lots of dispersion in the extent of *direct* impact contracting (some different directionality)

2. No explicit contracting (the Greenwashing case)
   - Not contracting can be optimal when task is difficult to measure (Holmstrom & Milgrom 1991)
   - Encourage parties to comply with spirit rather than letter of the law (Hart & Moore 2008)
   - We find that impact is also sufficiently embedded – could be that direct contracting is redundant
     - (Along with explicit contracting)

Contract Complementarities

	Operational impact			Limits to manager discretion		
	All	*MRS*	*NMRS*	*All*	*MRS*	*NMRS*
Investor return protection	0.268 (1.57)	0.268 (1.14)	0.342 (0.83)	**0.184*** (2.04)	0.242 (1.93)	0.0196 (0.11)
Indirect investor control	**0.335**** (2.64)	0.284 (1.26)	**0.426*** (1.99)	**0.342***** (6.23)	**0.449***** (4.76)	**0.216*** (2.62)
Limits to manager discretion	**0.582**** (2.35)	0.523 (1.54)	**1.335**** (2.27)			
Manager restrictions	**0.348***** (3.76)	**0.418***** (3.04)	0.259 (1.08)	**0.227***** (4.90)	**0.317***** (5.03)	0.0837 (0.81)
Aspirational impact	**0.348**** (2.75)	**0.530***** (3.00)	0.185 (0.75)	**0.285***** (4.67)	**0.317**** (3.32)	**0.200*** (2.27)
Operational Impact				**0.168*** (2.35)	0.161 (1.54)	**0.239*** (2.27)

- More terms in one area generally correlated with more terms in another area
  - Controls for number of documents observed

Additional Conclusions

- **Funds contract directly on impact – often but not always**
  - More contracting in MRS funds
  - Operational impact reasonably high at fund level, more mixed at PC level
  - Terms vary, especially at PC level, possibly reflecting particular type of PC
- **Funds also contract indirectly**
  - Advisory & support roles appear important
    - Some advisory roles stronger for NMRS funds
  - Adaptation of "boilerplate" provisions may promote impact goals
- **Operational impact terms in GP-LP contracts correlated with GP-PC contracts**
  - Suggesting investors' "impact imperative" is reflected in what PCs are contractually obligated to do

– **And *we conclude that impact investing that's reflected in contract terms is <u>not</u> greenwashing: impact is broadly operationalized.***

Some Implications for Industry

- **The heat of the conflicts and incentive differences that contracts address may be intensified in private market impact investing**
  - For example, when profit and purpose may represent dual direct goals, often without explicitly expressed tradeoff rules, preference and incentive difference may arise and complicate the relationships among parties
  - Conflicts appear to exist because operationalization and contracting exists and in some potentially costly ways
  - *Still be aware of possible greenwashing*

- **LP's should be aware of this expansion of conflicts and incentives as well as potential benefits of contracts along impact dimensions**
  - Impact is indeed operationalized (anti-greenwashing)
  - There are potential differences
    - E.g., traditional constraints on reinvestment my fall differently if reinvestment is desirable from a social perspective
  - Might some have a fiduciary duty to do so?
  - *Ask for or do operational due diligence incorporating impact*

Some Implications for Industry

For GP’s the bar is set: For both MRS And NMRS fund GP’s, contracts with portfolio companies extends across impact dimension and do it formally (and in an embedded way)

- The reflection of contracting down to the GP-PC relationship appears to have become (or at least in part) common, understood and important
- *Expect operationalization of impact including due diligence involving impact as well as requirement and reporting of measurement*
- *Support and supervision may also be expected (e.g., advisory committees with more power and deeper roles)*
- Vis a vis portfolio companies, without majority control, controls like *guaranteed board seats* may be the standard especially for funds seeking market returns (where the conflict may be strongest between profit and purpose)
    - This may be more expensive (LP’s listen up)

Some Implications for Industry

For portfolio companies

- Measurement and reporting on impact is either now or will (should?) be a part of your present and future. *Expect it to grow in presence and depth*
- *Especially* where the GP-LP relationship reflects operational (contractual) impact, on average expect to see it at the portfolio level
- Aspirational impact (embedded impact) is relied upon still, but that may not be sufficient (perhaps even where redundant)
- *Expect more supervision* (board presence, e.g.) especially where the dual goals exist together.