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Social Impact

The Governance of Impact Measurement in European Impact Investing Funds

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Preface

The objective of this report is to shed light on the topic of governance related to impact measurement and management (IMM) in European impact investing funds (venture capital and private equity). Whereas much has been written about the actual practice of measuring impact, there is less knowledge and transparency about how impact is integrated into management processes and how impact is governed in impact investing funds. We aim to address key questions including the following:

- How to allocate the IMM responsibility across the fund
- How to make investment decisions
- How to involve LPs in the fund's life
- How to measure and use impact performance metrics
- How to prevent investing in firms that shift away from impact and how to deal with exits

We embarked on this research project as part of a master's thesis at Esade Business School, and quickly realized that the results of the research could be of interest to a wider audience. It is our hope that this report will provide an interesting and relevant framework for impact investing funds that are being set up, so that they can learn from established funds and will not need to "reinvent the wheel." We also intend for this report to spark a much-needed debate in the impact investing sector around the important topic of governance.

Lisa Hehenberger
Director of the Esade Center for Social Impact

Executive summary

Impact investing funds have been growing their assets under management as well as their capabilities in impact management and measurement (IMM) over the past few years. However, there is still a **lack of transparency and best practice when it comes to the governance aspect of IMM.** Concretely, this report addresses how impact investing funds **allocate responsibility on IMM,** how **impact is integrated in the investment process** and how impact has **consequences on investment decisions and incentive structures.** We believe that these aspects are key components in the professionalization of the industry. This report is based on a combination of **desk research and interviews** with eight leading impact investing funds in Europe, in order to identify patterns in their IMM governance models.

Based on our research, we have detected **three main IMM governance models** implemented by European impact investing fund managers (see Figure 5). They are illustrated through the case studies of **Bridges Fund Management, Phitrust Partenaires and Rubio Impact Ventures.** These funds were chosen as prototypical examples of the governance model.

#1 Management-driven model (Bridges Fund Management)

In what we call the "management-driven model," the **IMM manager is supporting the investment team as an additional resource** to help them structure and carry out their impact targets. As these players are usually rather **large,** with various funds and sectors, the IMM team also serves to oversee and harmonize IMM frameworks across the entity. The IMM team reports to a member of the investment committee (IC), and not to the investment team. **Only the management team sits on the IC** as there are no external advisors or LPs involved in the decision-making process. Impact metrics are approved during the IC, along with the rest of the deal, in order to monitor the investment's evolution, flag underperformance and report to investors. Although they do have carried interest structures, these are not linked to the impact performance of the funds. They prevent mission drift (an investee shifting its business model away from impact) through their frequent **majority stakes,** giving them control of the investee's board, and therefore **do not include impact-related clauses in the term sheet.**

#2 Investor-driven model (Phitrust Partenaires)

Investor-driven structures are usually **smaller** and have more restricted resources, so that **impact and ESG responsibilities are spread across the investment team.** Specific members of the **IC**, which is made up not of management but of **investors or external advisors,** are tasked with challenging the investment managers on impact. Important decisions are validated by LPs. These funds usually invest **minority stakes,** giving them limited control over the investees. For this reason, they **include impact**

metrics in the term sheet as a flagging system and precautionary measure, enabling them to exit in case of mission drift. **Carried interest structures linked to impact metrics** are demanded by investors, and in case of success the carried interest proceeds are used to further the fund's mission (in Phitrust's case, through an endowment fund that provides grants and technical assistance to NGOs) rather than going to the investment team.

#3 Mixed model (Rubio Impact Ventures)

Funds that follow the mixed model are in **between the other two in terms of size.** Impact and ESG responsibilities are spread across the investment team, although there are usually **members of the team taking the lead and spreading expertise inside the fund.** The **IC** is made up of the **management team, but has to answer to external members** sitting either on the IC or an external board of advisors validating the IC's decisions. Investors are represented through a supervision committee made up of investors or external experts. They follow an impact carried interest structure according to the **EIF method**, which goes to the investment team. An impact advisory board has to approve impact metrics, which will determine the carried interest targets. When mission drift is a concern, **term sheets can include an exit clause or a veto on changing the investee's mission** (i.e., the investee cannot make any significant changes to its mission or business model without approval from the fund).

The most suitable model for each fund will depend on many factors, such as its resources, needs and culture. The profiles of investors in the fund will also impact the fund's requirements and expectations in terms of IMM. However, it is clear that no matter the model, funds are setting stricter processes and policies in order to standardize the way they work with impact. This standardization and coherence across deals and funds will send a positive signal to the market and contribute to the professionalization of the industry, enabling it to raise more and larger funds.

Best practices

Our research further allowed us to identify the following best practices:

RELATED TO GOVERNANCE

1

Whether through a dedicated staff or selected investment team members with additional responsibilities, it is important to **appoint "impact champions"** who will work toward improving the fund's IMM practices and standards. This also fosters accountability.

2. **Aligning incentives** can be done in two ways: through an impact carried interest structure and through variable remuneration incentives. The latter are based on the number of deals and operational improvements, as would be the case when adhering to the IFC operating principles on impact management.

3. The person responsible for IMM is rarely a member of the IC. But it is important for the **IMM responsible to have a direct route to the IC,** either through an impact memorandum document or by reporting to a different higher authority than the investment team. Most ICs have, officially or not, a member focused on impact to address related questions and concerns.

4. Impact funds rarely hire external expertise for impact because of the prohibitive cost, the current lack of suitable expertise in the market and the importance of having this core expertise in-house. Impact funds do, however, sometimes **outsource the work on ESG compliance** because of the potential economies of scale, as this is a complex activity that involves a lot of work and background checks, and is a different competency from those required to administer impact funds.

RELATED TO THE INVESTMENT PROCESS

1. IMM is an intrinsic part of the investment process and cannot be differentiated from the rest of the investment work. **Investment teams should feel as comfortable assessing a potential deal's impact as its economic outlook.**

2. **Decision-making processes are most often consensus based at each stage.** This ensures cohesion in small teams (as are typical in most impact funds), where motivation and alignment are key. It also makes the process less formal and helps make sure everyone is aligned with each decision.

3. **Impact is usually the first filter during the initial investment team discussion.** Deals are therefore first evaluated not on the basis of potential financial returns, but on strategic fit with the fund's impact areas and potential impact performance.

4. **Impact metrics are key,** and set together with investees to find the ones that are measurable and most appropriate. The strings attached vary, but they can become operational metrics guiding both the investees and the investment teams along their journey.

5. Mission drift is usually a main concern for funds. They avoid this by **selecting socially motivated founders** or by **finding business models with impact at the core,** which would not survive if the mission were changed.

6. **During exits, the option with the highest sustained impact is prioritized** over the financial returns, within possible limits.

Introduction

Impact investments can be defined as investments made with the intent of generating positive, measurable social and environmental impact along with a financial return (GIIN, 2019). This implies that the **impact** has to be **intentional** and **measured**, and that **financial returns** can be sought across a range of possible asset classes. According to the Global Impact Investing Network's annual impact investor survey, the industry now manages well over USD 404 billion in assets (GIIN, 2020).

Over the past decade, the industry has become more professional and sophisticated, and the perception of the industry has evolved. There is a global consensus that impact investing funds give increasing importance to impact measurement and management (IMM).

Introduction to IMM

Citing the 2015 report by the European Commission's Expert Group on Social Entrepreneurship (GECES), the social impact of an organization can be defined as "the social effect (change), both long-term and short-term, achieved for its target population as a result of its activity undertaken – taking into account both positive and negative changes, and adjusting for alternative attribution, deadweight, displacement and drop-off" (GECES Sub-group on Impact Measurement, 2013). **Impact measurement** is the measurement of social change achieved for the targeted population attributed to the activities of the organization during a specific period of time. The change might be both positive and negative, and there may be unintended consequences of one's actions to consider. Impact measurement involves three main dimensions: the impact measurement **process,** the **indicators** used (which can be standardized for specific interventions), and the **principles** utilized for reporting, transparency, and disclosure.

The process recommended in the GECES report was built on research conducted by the European Venture Philanthropy Association (Hehenberger, Harling, and Scholten, 2015) and included "identifying clearly the social impact sought, the stakeholders impacted, a 'theory of change' for social impact, putting in place a precise and transparent procedure for measuring and reporting on inputs, outputs, outcomes and for assessing thereby the impact actually achieved, followed by a 'learning' step to improve impacts and refine the process" (GECES Sub-group on Impact Measurement, 2013). This generic process is still valid today, although the level of sophistication with regard to the tools and best practices employed to perform each step has improved. Furthermore, the term **impact management** has gained traction in recent years as field actors have recognized the need to move beyond technical tools and frameworks to integrating impact in management systems. Impact management can be defined as the systems, processes, culture and capabilities related to impact measurement (Hehenberger, Buckland, and Gold, 2020). For impact investing funds, this means integrating impact into the investment process.

The importance of IMM

Impact measurement and management (IMM) is now recognized as a cornerstone of impact investing. However, despite most impact investing funds having increased the rigor of their IMM practices, further progress will address many key challenges of the industry over the coming years (GIIN, 2020), including the risk of "impact washing" (when a company or fund makes impact-focused claims in bad faith without truly having any demonstrable positive social or environmental impact) and the inability to demonstrate impact results or to compare them with those of peers. Currently, 97% of European impact investing and venture philanthropy funds measure social impact (Gianoncelli, Boiardi, and Gaggiotti, 2018), and over 70% publish impact reports (Bass, Dithrich, Sunderji, and Nova, 2020). These figures are expected to keep growing in future years, thanks to the added operational value IMM has for the funds, and driven by an increasing demand from regulators and investors in terms of accountability and transparency.

IMM is increasingly seen as both **an opportunity and a challenge for impact funds.** IMM governance is a key aspect of successful impact funds, as follow-on funds need to tighten their governance to comply with the increased scale and expectations of the fund (Chance, Bolton, Kurric, and Pereira, 2015). Indeed, investors in impact investing funds, especially institutional ones, now ask to see tangible evidence of the impact of their capital (European Venture Philanthropy Association, 2016). As funds gain size and attract more investment from institutional investors, strong IMM becomes a prerequisite. This includes a clearer separation of duties between fund management and Limited Partners (LPs), while finding ways to align incentives between both.

Understanding how IMM affects a fund's decisions, remuneration policies and other governance aspects is key to promoting the professionalization of the industry. A solid and transparent governance system will enable funds to grow unhindered and attract more capital, which ultimately should help them achieve more impact. As the collection of data through IMM becomes more sophisticated, impact investing funds will be able to rely on impact metrics in ways similar to how financially oriented funds rely on financial data (for incentives, remuneration, returns, etc.). Gaps in the governance of such funds, on the other hand, might have dramatic impacts on the industry, as trust among LPs, fund managers and investees, critical to the success of the funds, may be lost. Clear and transparent governance related to IMM is key to avoid the risks associated with impact washing.

The governance of IMM

Good IMM can mobilize more capital into the fund, which is why most funds consider impact measures to have business value (GIIN, 2020). However, questions regarding where IMM sits, who is responsible for IMM and the materiality of IMM are still largely unanswered. Since impact investing funds have dual objectives (financial and impact), in situations of potential trade-off or conflict between the two objectives, it is important to understand how a fund is supposed to act. The governance structure needs to be set up to reflect the main responsibilities and accountabilities of the fund.

There is still a lack of consensus on the definition and scope of IMM, and commonly accepted best practices regarding governance are few. Investment funds generally have traditional governance rules based on the fund's financial return and employee hierarchy. However, some impact investing funds have created different rules to reflect the importance of their social impact purpose.

Methodology

We developed this report based on a combination of desk research and in-depth interviews with impact measurement experts at some of the pioneer impact investing fund managers in Europe. The sample was restricted to European impact funds for which impact investing was the main activity. We also tried to sample funds from different countries and stages of development in order to see the different models. Some other entities than impact funds were contacted, such as impact platforms or LPs, in order to gain additional insights into the market.

Each time the discussion was held with the person in charge of IMM in the fund, whether that was a specifically dedicated role or someone doing it part time. This approach allowed us to acquire the most precise information. Because of the COVID-19 pandemic all interviews were conducted on Zoom and recorded in order to be more easily transcribed later on.

We followed a semi-structured interview process, where broad themes had to be covered but with flexibility in order to focus further on interesting topics depending on the conversation. This allowed us to compare information and processes across funds, while going in deeper into the specificities of each.

After careful analysis of the results across the study, three models came out of the data. One fund was therefore chosen as a case study to illustrate and dig deeper on the specificities of each model.

We are grateful to the institutions and individuals listed in Table 1 for generously sharing their insights about how their funds incorporate impact.

Table 1: List of interviewed institutions ↓

Institution name	Name of contact person	Country
Bridges Fund Management	Antony Ross	UK
Oltre Venture	Gaetano Giuffrè	Italy
Rubio Impact Ventures	Laura Cramer	Netherlands
Creas	Lara Viada	Spain
Phitrust Partenaires	Danaé Becht	France
Investir&+	Mari Kameyama	France
Investisseurs & Partenaires	Samuel Monteiro	France
Lightrock	Marc Moser	Switzerland

Part 1 IMM and IMM Governance

Impact Measurement and Management in an Impact Investing Fund

IMM is about integrating impact measurement into the operational processes of a fund in order to consciously track and act on impact performance.

Impact measurement and management involves many different tasks that are performed at various points in the lifetime of a fund. A typical impact investing fund will go through the same process as a regular investment fund, starting with the investment strategy and culminating in the exit. However, there are some important differences when it comes to the integration of impact. The IFC Operating Principles for Impact Management[1] provide concrete recommendations for how this integration should be executed in an impact investment fund, with further scrutiny recommended through public disclosure and independent verification.

During the investment process, IMM will involve providing inputs to the investment team when structuring deals and presenting them to the investment committee (IC) in terms of impact. These meetings and materials will be useful in enabling the IC to understand the specific impact aspects of each deal and keep striving for more impactful portfolios. As the fund advances, constant improvement will be required in order to refine this view using external inputs (external feedback, best practices, industry standards, etc.) and internal inputs (feedback from deals and team experience). Figure 1 summarizes how impact can be integrated into the impact investment process. In what follows, we provide a brief outline of how this can be done in practice. The EVPA guide (Hehenberger, Harling, and Scholten, 2015) was intended to make sense of the myriad of frameworks and tools to develop best practice recommendations valid at the level of the impact investor and the social enterprise. Our outline is based on prior research building on the EVPA guide, while integrating various tools, taxonomies and frameworks that are currently commonly used in the impact investing sector.

1 Operating Principles for Impact Management: https://www.impactprinciples.org/

Figure 1: Integrating impact in the investment process ↓

Investment Strategy

Decide on the **impact objectives – the impact thesis -** of the impact investor, according to its *'theory of change'* and aligned with **target SDGs.** This will guide the investment process.

The Impact Investment Process

Deal screening

Screen deals according to the impact thesis of the impact investor – should help impact investor achieve its impact goals.

Due Diligence

Conduct **due diligence** developing specific questions related to the **IMP dimensions**: *What, Who, How much, Contribution and Risk.*

Deal Structuring

Develop **impact objectives** for investee to achieve during investment period. Define **KPIs to measure** – use standardized indicators where possible, e.g. **IRIS+**. Define non-financial support.

Invest Management

Monitor **progress towards impact objectives** at regular intervals (more often for outputs, less frequently for outcomes). Suggest **improvements** if necessary.

Exit

Conduct exits considering the effect on sustained impact.

Evaluation & Post-exit Follow-up

Evaluate **degree of achievement of impact objectives.** Include data in **impact report** of impact investor. Include **learnings to improve impact management** of fund.

Source: Hehenberger, L. & Buckland, L. (2020). *How impact measurement fosters the social economy: From measurement of impact to learning and management for impact.* European Commission Joint Research Centre report.

INVESTMENT STRATEGY

During the setup phase, IMM involves designing the impact framework, tools and strategy that will be used for marketing while fundraising takes place and during the investment period. These will allow the team to map out and agree on why and how the fund will achieve impact. Before each fund starts, the team should decide which impact theme it will focus on, as well as its target geography, sector, investment phase and portfolio size. Some impact investing funds develop a 'theory of change' to explain their ultimate impact objective and map out the activities, outputs and outcomes that should lead to their impact. Others more generally state that they are targeting specific Sustainable Development Goals (SDGs) in their target market.

DEAL SCREENING

The pipeline is created in accordance with the investment strategy. The potential deals are filtered on the basis of impact as well as financial criteria, and potentially other factors. As the potential deals pass the various screening filters, each opportunity is evaluated in terms of the potential impact it will be able to achieve, as well the IMM system it has in place.

It is important for the potential investee to achieve an impact that will contribute to the investor's impact goals. While it is frequent for an investment to only match part of the investor's impact goals, the combination of the whole portfolio should cover the investor's range of impact goals.

Understanding the level of sophistication of the IMM system of the potential investee is also key because it allows the impact investor to understand how much it can trust the evidence provided; and to what extent the investee will require support to improve its IMM.

DUE DILIGENCE

The Impact Management Project[2] decomposes the somewhat lofty concept of impact into more specific categories of *what, who, how much, contribution* and *risk.* In terms of indicators, the IRIS+[3] taxonomy, promoted by the Global Impact Investment Network, has become a standard in the sector. Combining the IMP categories with the IRIS+ indicators allows for a structured approach to develop due diligence questions related to impact.[4] This enables the investor to standardize its due diligence process and compare each deal to different benchmarks before structuring the final agreement.

DEAL STRUCTURING

As part of the deal structuring stage, the impact investor, together with the investee, defines the impact objectives that the investee should aim to achieve during the investment period. This involves defining indicators in terms of outputs (to be measured frequently) and outcomes (to be measured less frequently). If possible, the indicators should be taken from existing libraries and taxonomies such as IRIS+.

INVESTMENT MANAGEMENT

Once the deal has been structured and signed, the investee becomes part of the portfolio and forms a close bond with the investment team. The problems of the investee will become the problems of the investment manager, who will help solve them. Investors require receiving updates on progress and seeing how the companies are doing financially and impact-wise.

If issues arise, investment managers or investees might need help to deal with specific issues. Exit options will also need to be evaluated in terms of sustained impact in order to maximize both the financial and impact return. If more than one exit option is available, the different buyers will need to be evaluated and a plan to sustain impact in the future might be elaborated to ensure it does not disappear after exit.

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2 Impact Management Project: https://impactmanagementproject.com/
3 IRIS+: https://iris.thegiin.org/
4 IRIS+ for Impact Due Diligence: https://iris.thegiin.org/document/iris-for-impact-due-diligence/

EXIT, EVALUATION & POST-EXIT FOLLOW-UP

Based on the evolution of each investee, actions might need to be taken to improve the performance not only of a specific firm but also of future ones that might undergo similar situations. Investees are opportunities for learning and improving the team's experience and ability to cope with problems in the future, as well as for helping the team to better understand the work it does and how to attain the results it wanted.

Furthermore, depending on legislation and fund structure, external verification might be required or desirable in order to validate the results and numbers before publishing them. Funds that follow the IFC Operating Principles need to put in place some sort of verification of the integration of impact in the investment process. This verification may be performed by an external consultant or internally by someone other than the investment team.

Impact investing fund managers often also develop impact reports that include the performance of the entire fund as well as in terms of individual deals. These reports are published on their websites and included in the material distributed to investors.

The main IMM tasks, which are described in the foregoing paragraphs, are summarized in Figure 2. In Figure 3 we depict the main goals of IMM governance, which are elaborated in the next section.

Figure 2: Summary of main IMM tasks ↓

Investment Strategy

- → Design the impact framework, tools and strategy
- → Improve these as best practices evolve, and as the fund gathers experience and feedback

Deal Flow

- → Assist the investment team in structuring deals and presenting them to the IC
- → Help the IC understand the impact side of each deal and push the quality of work upwards

Investment Management

- → Help investees or investment managers deal with impact issues
- → Evaluate exit options in terms of impact and assess sustained impact after exit

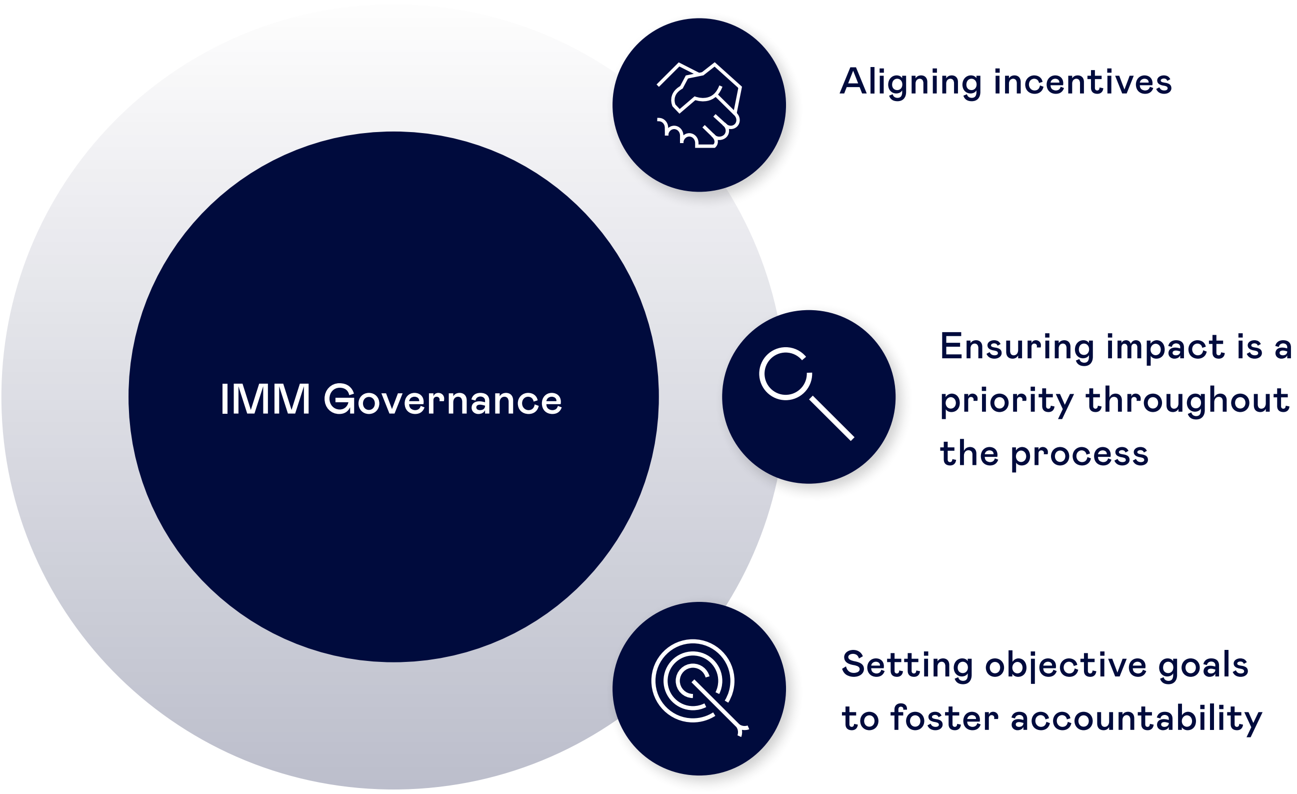
Evaluating, verifying and reporting

- → Measure impact performance at investee, portfolio and fund level
- → Analyze results and report to investors

Source: Own elaboration

The importance of IMM Governance

Figure 3: IMM governance goals



Source: Own elaboration

As explained in Figure 3, IMM governance is about:

1. Aligning incentives among investees, investors, and the investment team.
2. Ensuring impact is a priority throughout the process.
3. Setting objective goals to foster accountability.

Many stakeholders are included in an impact fund. The Limited Partners (LPs) invest capital into the fund, hoping to achieve both a financial and impact return. The General Partners (GPs) and the investment team find and manage the best companies to invest in, with the goal of achieving these dual results. The companies invested in (investees) are looking for capital and often non-financial support to grow in a sustainable manner. Finally, the beneficiaries of the end products or services of the investees benefit from the actions of the investees either directly or indirectly.

Although the assumption is that all stakeholders care about impact, their individual perspectives, incentives, and motivations might not always converge. Therefore, it is important that objectives and incentives be clarified in order to avoid potential conflict. Objectives can be clarified through official documents and statements (such as a 'theory of change') for each fund, stating the intended results. Investment managers may be remunerated based on their financial performance and/or their social impact, in order to encourage them to grow investees' impact and financials. Investees can be encouraged to measure and systematize their impact by integrating impact metrics into their decision-making process. Finally, investors may be interested in achieving the broad impact objectives of the fund as well as encouraged by the progress made by individual investees.

Therefore, if IMM is not structured correctly, it will be difficult to align incentives across all stakeholders. Indeed, impact funds will survey dozens of different potential deals looking for the perfect fit. While impact funds look for financially attractive deals, the social impact aspect is paramount and a qualifying criterion for each investee, not only at the screening phase but later on. Having a standardized and formal process to manage this is key to making sure it remains a priority. When choosing between different deals, the investment team will sometimes have to favor or discard deals based on many criteria, but it is key that impact should be one of the main ones.

During the investment period, using IMM to determine impact performance can give investees an incentive to measure their impact and always strive for more, possibly to attract more financing in the future. Investment teams will use the impact performance scores to gauge their progress and might be financially incentivized based on the results.

Furthermore, when investees need help, investment teams will need to dedicate valuable time and resources to solving issues and will need to choose which investees to prioritize. Based on how the investment team's work is evaluated, the results might be different. When it comes to exiting, different buyers might lead to radically different outcomes in terms of impact, as each buyer has its own reasons for the acquisition. It is up to the investment team to pick the right buyer for each deal, considering both economics and impact.

Finally, proper IMM allows setting objective goals at each level of the fund, which fosters accountability in a challenging environment where everyone is always striving to generate more impact. In the same way, IMM can be used to identify and solve problems, as well as to compare across deals. LPs are keen to be informed of the impact their capital is having, and having proper metrics motivates not only them but also investees and investment teams. But these communications to investors should be done in a clear and concise manner, making it easy to grasp and analyze the data. Without such considerations, investors will find themselves unable to challenge or simply understand these metrics, which would defeat the purpose.

This is why IMM should be set up carefully, so that institutional investors can trust in good IMM governance before expanding their investments into the industry. Solid IMM governance also reduces the risk of impact washing and contributes to setting industry standards, as well as improving impact efficiency for investment teams. All these aspects will go a long way to help achieve the impact that the funds are aiming for.

> The problem with IMM is that there is no widely-used standard in the sector yet. When there are no standards, everyone can do whatever they want. You can say anything about your impact.
>
> Danaé Becht (Phitrust Partenaires)

Part 2 How IMM Governance is implemented

How to allocate the IMM responsibility across the fund

Funds either assign the IMM responsibilities across the whole team, to a specific member of the team, or to a full-time team. But it is key that the operational tasks of IMM stay with the investment team.

While it is commonly agreed that IMM tasks (especially operational ones) should not become completely separated from the investment aspect of deals, IMM needs to be harmonized across the fund as well as improved continuously. Leaving the operational and day-to-day IMM responsibilities to the investment team is key in order to ensure that teams are experts both on financial and impact aspects. Not splitting impact from the rest of the investment team's work also reduces the number of interlocutors with investees and facilitates the relationship. But extensive work is still required in order to create a fund's IMM processes and update them using the feedback from past investments as well as industry evolutions. Some funds spread this responsibility across the team, while others prefer to have a specific person appointed responsible for these tasks.

The IMM role might be given to a member of the investment team who will take this role on top of his or her current investment role, whether formally or not. For fund managers with several impact investing funds under management, and for larger funds where IMM needs to be harmonized across a large number of deals, a specific IMM team is often set up as an additional resource. This team is usually made up of at least two individuals, who will help the investment teams with impact considerations as well as spread knowledge on IMM best practices within and outside the fund.

The relationship with the investment team is one of collaboration rather than compliance. This is key to ensure buy-in from the investment team and make sure that the main objective, which is to have impact-conscious and trained investment teams, is achieved.

It is also important to note that this staff tends to fulfil the same functions on Economic, Social & Governance (ESG) issues as it will

> We did not want the entrepreneur to have two different interlocutors, with one focused on operational and business matters and a different one focused on impact, as if it were an addendum.
>
> Samuel Monteiro (Investisseurs & Partenaires)

on impact. While many funds already have ESG policies in place and industry best practices for ESG are more established, impact funds recognize the importance of continuous improvement and often try to improve their capabilities on both ESG and impact. They do stress the difference between the two, however. ESG has a notion of risk, of compliance with standards, while impact is linked to an impact thesis with targets and objectives.

The person responsible for IMM tends to be called ESG & Impact Manager or Impact & ESG Officer, or variations thereof. We will refer to the role as the "IMM responsible." The IMM responsible often reports to a different authority than the investment teams, an arrangement meant to guarantee its independence. This allows for more freedom and legitimacy to challenge investment teams in their assumptions and decisions, and help them go further in their reflection. In case the IMM responsible considers that a specific point is not given appropriate importance by the investment team and that the IC might not be provided all the necessary information, the IMM responsible can inform his/her superior – who often sits on the IC – so that proper and complete information is supplied during the decision-making stage. This way, the IC will be informed both of the Investment team's and the IMM responsible view, and be able to make a conscious decision.

Some funds formalize this by consistently preparing a specific Impact memo for the IC, which will inform the IMM aspect of the deal in a brief and concise form. However, having a dedicated team for IMM is a significant financial burden. Its justification will depend on the experience of the investment team in terms of impact, as well as the fund's complexity which can be indicated by the number of different strategies and impact themes the fund covers.

> Before deliverables go to the global [investment committee (IC)], I want to see them, review them and provide feedback to the deal team so they can address comments and improve things. It is a quality check we have, as information from standardized tools, assessments and deliverables needs to be summarized in IC memos and submitted to the IC, and the IC draws conclusions based on this.
>
> Marc Moser (Lightrock)

> It is important to distinguish between the notions of ESG and Impact. ESG generally is about risk regarding established standards. Impact is more about targets and objectives related to an impact thesis.
>
> Samuel Monteiro
> (Investisseurs & Partenaires)

> We do not want to separate the investment part from the impact part, to have a financial person that just follows the investment's economic performance without caring about the impact.
>
> Gaetano Giuffrè (Oltre Venture)

Lightrock

The Impact & ESG responsible (1 person) develops and maintains all the relevant systems and processes, as well as the tools, and templates to measure and manage impact. For each investment, he/she supports the investment teams in completing the assessments and building the impact narrative before presentation to the IC, especially if there are more complex cases.

How to make investment decisions

Impact should be the first filter at every stage, and funds can involve external opinions to challenge assumptions, but it is important to reach consensus and bring everyone on board in the end.

In case someone has been appointed IMM responsible, this is rarely a sufficient reason to be invited to the IC, except to discuss specific and rare issues. Members of the IC, however, are expected to be trained in impact and ask the right questions. It follows that, no matter whether the IC members are chosen among the investment team or LPs, experience in impact investing is a prerequisite.

> It is not a vote but rather a group discussion. If we see disagreements, we go through them and try to find a solution. There is never a vote that ends with, say, 5 for and 4 against.
>
> Samuel Monteiro
> (Investisseurs & Partenaires)

The IC can be made up of different types of individuals including investment team partners, LP representatives, as well as external advisors. External advisors often have the responsibility to challenge the investment team and make sure procedures are followed and that each deal upholds the same quality standards.

In some cases, a member of the IC will be deemed the "impact champion," formally or not, and will be expected to pay extra attention to the impact dimension of each deal, and be the one to push the decision on these topics.

Investment decisions are rarely decided by votes and most often by consensus. In small structures such as impact investing funds, finding common ground and engaging the different members of the team is key.

In some structures, a separate impact committee is set up, whose goal is to check the impact dimension of each deal and ensure that the impact metrics used are appropriate for the company and ambitious enough for the investment. This serves a dual purpose of ensuring that all deals are checked externally for fit with the fund's impact themes and strategy, as well as pushing the investment team to strive for more ambitious and coherent impact performance.

In cases of impact carried interest structures, these external impact committees provide independence from the investment team, and reduce the risk of conflicts of interest when setting the targets upon which the investment team will be evaluated. The Social Impact Accelerator (SIA)[5] of the European Investment Fund requires the impact investing funds that it invests in to implement a social impact carried interest structure and therefore insists that independent advisors or LPs should validate these impact metrics.

ESG due diligence and background checks are sometimes outsourced to specialized actors in order to benefit from their expertise and economies of scale. This is especially true for large majority investors which have to comply with certain ESG requirements and check potential deals across exclusion lists. When acquiring international and diversified firms, this thorough research might become too complex for the investment team's capabilities and resources.

However, our research suggests that few funds rely on external expertise to carry out specific due diligence research or other tasks when it comes to impact. This is often a consequence of the significant expertise of investment teams in impact, as well as the high cost that would be entailed in outsourcing this function. However, multiple funds believe it is important to have external members challenging the investment teams at different points of the process, in order to give a neutral view on a deal's potential impact risks and rewards. On top of the previously mentioned mechanisms, they sometimes invite academic experts to discuss deals and lend their field expertise and opinion. These experts often sit on the IC – or on a separate impact committee – but sometimes have a non-voting seat where their opinion is mostly informational. This is the case for Oltre Venture, for example. An expert attends the weekly team discussions in order to discuss projects in specific fields, but does not take part in the voting procedure. Other funds work together with universities and research centers to go deeper on certain impact topics and provide more data grounded in field research. This contributes to the rigor of the fund's impact evaluation while enriching the ecosystem and bringing more varied points of view to the table. Investisseurs & Partenaires, for example, works with doctoral students who create in-depth impact assessments for selected investees and research topics to further improve the firm's IMM capabilities.

> “Once we have discussed the deal at length between ourselves, and feel like we have something solid to defend, then we go to the investment committee with external people who will challenge the deal.
>
> Samuel Monteiro (Investisseurs & Partenaires)

> “We are talking with our auditing firm about auditing our impact, but this is still in very early stages. It is something new we are exploring. A lot of auditing firms do not know how to audit impact yet, so we are learning with them. I definitely believe we are going to go there in the next few years.
>
> Laura Cramer (Rubio Impact Ventures)

> “We like to have doctoral students to reflect more deeply on IMM, to have partnerships with universities, etc. It allows us to ask ourselves questions, to test our hypotheses and evaluate what the best way to measure impact is.
>
> Samuel Monteiro (Investisseurs & Partenaires)

5 EIF. The Social Impact Accelerator (SIA): https://www.eif.org/what_we_do/equity/sia/index.htm

Oltre Venture

Oltre has a board of directors which approves investments (the equivalent of the IC in other funds). On this board sits an independent member, whose task is to review and challenge the deals before they are approved. That person is chosen by the partners of the fund, in agreement with the investment team, for relevant experience in the social field and in investment finance, and only takes part in the board of director meetings.

This advisor is therefore an independent board member, not involved in the rest of the management process, and totally independent in opinions. The fund partners are legally required to verbalize and take note of comments before any investment decision.

How to involve LPs in the fund's life

i

LPs often have a lot of experience and motivation to bring to the table, and can contribute during deal selection, through non-financial support, or approving impact targets.

No matter whether the LPs are private or institutional, they are naturally often very interested in the health of the funds invested. They might also have valuable expertise to bring to the table and be able to contribute advice to investees, on top of their financial investment. This can occur through technical expertise, experience, networks, and general advice.

> Once a week we present two or three projects we worked on in the past days and ask for their [the LPs'] opinion. Do they think they are interesting in terms of impact? What do they think of the business models? The markets? Sometimes our LPs will give us hints about what to check on a particular kind of business model or about what's important in a certain industry. In this way, they are involved in that first decision-making phase and help us with their expertise and interest, so this is great.
> Mari Kameyama (Investir&+)

Especially in impact funds, private investors often are very keen to contribute to the development of the investees and will be delighted to coach these or sit on boards. Institutional investors can also appoint experts to sit on these boards in order to make sure the investees are correctly managed.

> We have many LPs, but not all of them are on the investment committee. Any LP can request to join, and we make an effort to have a balanced mix of profiles. We split LPs in 3 'colleges' based on their profiles and interests: impact, entrepreneurship and finance. We try to have a minimum representation of each at every meeting to avoid discussions where, for example, no one is focusing on impact. This way we have a really global and exhaustive vision of all potential deals.
>
> Mari Kameyama (Investir&+)

In general, LPs can weigh in on the process either in this way or else at the fund level, where LPs sit on the IC, through their IC participation. They might also contribute to the validation of the impact metrics in order to make sure these are ambitious enough and appropriate for each investment. This helps ensure that the metrics are discussed and challenged, and also that investors, who will be the ones to effectively pay the impact-based financial incentives, are included in the process.

> This is what committees are for, to question things and ask smart questions. They challenge us on our assumptions, never with a negative outlook but rather as constructive criticism.
>
> Lara Viada (Creas Impacto)

Finally, LPs have the opportunity or even the duty to check the impact reports and try to evaluate and understand the performance reported to them. Therefore, the reports should be done frequently and clearly so that LPs can grasp the issues well enough to be able to challenge and hold the investment team accountable.

> Post investment, we monitor impact performance and start reporting on it. We publish annual reports, but we prepare interim reports as well to make sure that the original thesis is valid. As with financial performance, some investments will overperform and some will underperform [in terms of impact], and we will report that to investors. They will see how the business is doing in its impact metrics and where it's likely to get during our period of ownership, and it is important that they are able to understand our numbers and to challenge them if needed.
>
> Antony Ross
> (Bridges Fund Management)

Phitrust Partenaires

Many of Phitrust's investors are private individuals keen to contribute to the success of the ventures invested in. They therefore are willing to give time and energy to helping the investment team with deal flow decisions, as well as sit on the boards of the investees in order to provide further mentoring and expertise. These investors might meet monthly together with the investment team to discuss evolution and provide advice on the next steps. They may then be selected based on their experience and compatibility with the specific investee to sit on its board and contribute to its growth.

Impact metrics

Impact performance metrics can be used as a flagging system to monitor investee evolution and exit early if needed, or to measure fund performance and align incentives.

Setting impact metrics has become a commonly agreed best practice to impact investing, as it allows for tracking of the impact performance over the investment period and a more quantified vision of impact.

Ideally, these metrics will also serve investees in their day-to-day operations, as operational and strategic metrics, to guide their decisions. As most firms invested in by impact funds have a social mission and target beneficiaries they are trying to help, the right metrics can be a way to keep in touch with their beneficiaries and their impact. This is why it is key for investment teams to set the metrics together with the investees, so they can become an essential part of the investee's own management and not an additional reporting burden.

Monitoring the progress against impact objectives permits the investment team to see which investments are doing better or worse than expected, and act in those cases where interventions are necessary. Impact metrics allow the investment team to measure the performance of each investment and compare between those across the whole portfolio.

> Of course we will also check how eager they are to implement these metrics, and if they already measure their impact. A three-year-old firm that has no impact metrics and cannot give us any data might not be a perfect fit. Given their strategic importance, impact metrics should be something operational and integrated in their work.
>
> Danaé Becht (Phitrust Partenaires)

> We choose the metrics together with the entrepreneurs, so they can really create and own them. We do not want metrics to be just for investor reporting; they should be something strategic and useful for investees to monitor their activities, like classical KPIs.
>
> Danaé Becht (Phitrust Partenaires)

Some funds use these metrics simply as a monitoring system, to anticipate problems and act before it is too late. Others will tie certain consequences to the evolution of the performance, such as early exit options or impact carried interest structures. They are invaluable for reporting to LPs and the broader public curious to know how the fund's impact is evolving in a quantified way. Impact funds' own teams might also be interested in quantifying their impact and seeing in hard numbers the results of their work.

Early exit options would imply that the fund divests its stake in an investee where the impact performance is significantly below expectations. This is a significant deterrent against mission drift (an investee shifting its business model away from impact), but generally more a preventative action or warning than something impact funds would actually do. Indeed, it is better for everyone to avoid coming to that. These metrics can also be used to set targets at portfolio level in order to evaluate the general performance of the fund and assess whether the investment team deserves some kind of reward.

In terms of financial incentives, various models exist. However, common to all funds is the belief that investment teams are intrinsically motivated by impact and really believe in the mission of the fund. Their main driver is therefore in the work they do. Metrics can then be a way to make the result of their work more tangible and public. Other incentives can be added, such as operational incentive schemes and social impact carried interest structures (at portfolio or investee level). The different models are outlined in what follows.

SOCIAL IMPACT CARRIED INTEREST

These structures are an extension of the typical carried interest structures seen in investment funds. In these schemes, at the end of the fund's life, the financial performance is evaluated, and the investment team has the right to a predetermined share of the profits, given these profits are above a certain threshold.

A social impact based carried interested structure follows the same pattern except that the social impact performance is used instead of – or often complementary to – the financial one. At the end of the fund, both the financial and impact performance are measured and, if the performance is above a certain threshold, the fund's management team will receive a share of the profits.

This share can be either partially linked to each performance dimension (a separate amount if each of the targets are met) or entirely linked to its combination (the fund management team will receive none of the fund's profits if both of the targets are not met). The threshold targets can also be either binary (the management team will receive 100% of the carry if the threshold is met) or in tranches with various threshold targets. In these structures, each target reached will correspond to a different financial incentive.

Supporters of impact carried interest structures will say that this is a way for the fund's management team to commit to its impact performance and be rewarded if more impact is achieved. However, some impact funds are opposed to implementing such a social impact carried interest, because they believe that the team is already intrinsically motivated to achieve impact and that such incentive structures would affect its behavior. Investment teams might then choose a firm with slightly lower impact potential but stronger economics over another.

One could argue that integrating social impact in current incentive structures can be a good way to standardize the industry and push for more rigorous, consistent, and quantified impact management. Having such a result would help the industry move towards professionalization and attract more institutional investors who are still to enter the industry. This latter objective is supported by the EIF's SIA fund of funds, and the reason why it insists on setting up such a structure in all its investee funds. In order to do so, the calculation of the impact performance is key. In the funds interviewed, the main method was the EIF's impact performance calculation method outlined in Figure 4 as implemented by Rubio Impact Ventures.

OPERATIONAL INCENTIVES

Some investment teams receive an additional financial incentive based on their operational activity and progress. This can be measured through the number of deals evaluated, invested in, exited, or simply an appreciation of the quality of deal flow. Evergreen funds (funds that do not have a close date and therefore cannot determine their final performance) most often employ that method.

Figure 4: Weighted impact performance target calculation method as implemented by Rubio Impact Ventures ↓

The Weighted Overall Social Impact Target is calculated each quarter to determine the fund's actual impact performance compared to the three-year impact target set at investment date. The Weighted Overall Social Impact Target is calculated as follows:

1. 1-3 Impact Key Performance Indicators (KPIs) are determined per investment.
2. Each KPI is assigned an impact weighting within the specific investment – as some KPIs are more relevant than others.
3. For each KPI a three-year impact target is set and validated (pre deal) by our Impact Advisory Board and finally (post deal) determined and approved by the Investor Counsel.
4. The Final Overall Social Impact Target per investment is calculated by setting off the actual impact reached against the three-year impact target multiplied by the assigned impact weight per impact KPI.
5. The fund level Weighted Overall Social Impact Target is calculated by multiplying the Final Overall Social Impact Target per investment by the relative investment weight of that investment.
6. We report the Weighted Overall Social Impact Target of our portfolio companies to our investors each quarter.
7. The fund overall impact hurdle at exit is minimum 60%, but we of course aim to exceed 100%.
8. The Weighted Overall Social Impact Target per 2019 year end is 38%.

38%

Source: Rubio Ventures Impact Report 2019

How to prevent mission drift and how to deal with exits

To reduce the risk of investees shifting away from impact, funds can focus either on the founder's impact motivation or the business model, and invest only in those firms where impact is at the core and switching would be really complex.

Mission drift is a key concern for impact funds. Since they invest on the premise of impact, being invested in a company where this impact has disappeared is damaging to both their results and reputations. Funds employ various techniques to avoid this situation.

The common solution is to include this aspect in the selection filter and only invest in firms where the mission is an intrinsic part of the business model and where economics and impact are perfectly aligned. This ensures that as long as the business model remains the same and the firm grows economically, so will its impact. Furthermore, it reduces the chances of short-lived impact after exit, as a buyer would have to change the whole business model of its recent acquisition to do so.

The easiest solution is therefore to invest only in deals where there will be no trade-off between financials and impact at exit. Those types of investees tend to be the ones where by growing the company in terms of sales, they also impact more people. An example could be an EdTech company that implements an innovative solution to help children improve their mathematics skills. Once the solution has been tested to work, if scaled up, more children will benefit from the impact.

> Most of the time we try to find companies that have a double path—an impact path and an economic path that go together and can scale together.
>
> Gaetano Giuffrè (Oltre Venture)

Some funds also like to ascertain the social motivation of the founders, in the belief that if the founders are focused on social impact, they will strive to keep the firm's impact focus no matter what. They therefore engage in serious conversations with the entrepreneur until they are convinced that the entrepreneur would dislike seeing the firm's impact disappear as much as they would.

> We really try to create a bond with the entrepreneur and get to know each founder, to understand their motivations and show them how we can help. We meet many times and ask them why they want us to invest, what they are looking for, etc., because we want to provide more than just capital. You cannot build a relationship if there were only two meetings on each side during the due diligence.
>
> Danaé Becht (Phitrust Partenaires)

In a majority of cases, our interviewees mentioned that the mission of the investee was stated in a legally binding manner in the term sheet or the articles of the company, which reassured the funds. In case the investees were to take another direction and move away from impact, this could give them legal grounds to block it or exit. In a few cases there were actual exit clauses included, but the funds mentioned that they did this only in cases where the business model had a risk of mission drift and as a last recourse.

> Whenever we have doubts that the firm might shift away from maximizing impact, we also include a lock-in, meaning that if one day it deviates away from impact, then we as a fund will have a right to exit.
>
> Lara Viada (Creas Impacto)

Specific clauses can also be included in term sheets in order to give funds options to block or get out due to changes in the mission. These can be tied to specific impact metrics which will be used as a ground for clause activation. For example, a fund will have the right to exit if a specific impact metric falls below a predetermined level. This is mostly used as a deterrent, though, and investment teams prefer solving the problem together with the investee whenever possible.

Funds with larger stakes (and therefore greater control of the board) seem to put fewer such constraining clauses in their term sheets. Their board seats give them control over any major changes, while funds investing smaller stakes often include an exit clause in case the company shifted from its impact mission.

In cases where there might be a tough decision to make, the investment team will have to evaluate the options available and act according to their fiduciary duty and their bylaws.

However, funds can create an action plan for each exit in order to sustain the impact after exit and smoothen the transition.

In funds where an impact committee exists, this committee might intervene to validate the buyer or weigh in on the decision-making in order to make sure that the exit is done with the right timing and the right buyers to sustain the impact as much as possible.

> At the end of the investment, we know the [investee's] track record on the impact side during the full period, which we summarize, but we also try to showcase our contribution, both financial and non-financial. Where we opened doors, where we helped them develop and build things, etc. We collect all the data and do an exit assessment on both impact and ESG. We go even further by helping the company develop strong impact material for future investors and consider mission continuity when selling to the next investor.
>
> Marc Moser (Lightrock)

Investir&+

At Investir&+, the team filters its deals on impact as a first selection, making sure it is present, measurable and with potential to increase. Then it will look for business models where impact and financials are aligned, but also spend a lot of time understanding the motivation and background of the founding team. An impact-focused founding team will be more likely to find solutions to keep the impact trajectory of the company no matter what, and reduce the risk of mission drift. They then decide, together with the investee, on 2 or 3 impact metrics that they will track together over the investment period. These metrics mostly serve as a performance indicator and a deterrent against mission drift, since low performance would trigger a clause included in the term sheet allowing Investir&+ to exit.

Case Studies

In order to dig deeper into the specificities of each model, we decided to select three funds within our sample that we felt best represented a certain way of governing impact and measurement.

The funds detailed below were therefore chosen as such and, although no two funds are alike, they do share characteristics with other similar funds within their governance model.

Our case studies are summarized in Table 2.

Table 2: Case study essentials ↓

Name	**Bridges Fund Management**	**Rubio Impact Ventures**	**Phitrust Partenaires**
Website	https://www.bridgesfundmanagement.com/	https://www.rubio.vc/	https://www.phitrust.com/impact-societal/phitrust-partenaires-europe/
Assets under management	> €1 billlion	€150 million	< €25 million
Location	London, UK	Amsterdam, Netherlands	Paris, France
Geographic activity	National (UK)	Regional (Western Europe)	International (France, Europe, Asia and Africa)
Typology	Private Equity Firm	Venture Capital Fund Manager	Venture Capital Fund
Year founded	2002	2014	2003
Number of funds	13	2	2
Asset types/ Activities	Property, growth, long term capital and outcome-based contracts	SME investments	Early and growth stage investments
Investment themes	Health and wellness, future skills, sustainable planet, stronger communities	Circular solutions, people power (future skills and jobs), health and wellness	Future skills, social housing, circular economy, social integration

Bridges Fund Management

At Bridges, there is a two-person team working on IMM and supporting the investment teams. They do not have an impact carried interest yet. Only partners sit on the IC.

Table 3: Bridges Fund Management Fact Sheet ↓

	Bridges Fund Management
Typology	Private Equity Firm
Team size	15-50
Year founded	2002
Name of founder(s)	Sir Ronald Cohen, Michele Giddens and Philip Newborough
Location	London, UK
Geographic activity	National (UK)
Asset types/activities	Property, growth, long term capital and outcomes contracts
Investment themes	Health and wellness, future skills, sustainable planet, stronger communities
Assets under management	> €1 billlion
Principles for responsible investment	Yes
Number of past investments	63
Number of funds	13

INTRODUCTION

Bridges is a UK-based fund manager specializing in private markets investments. It has been investing in solutions that support the transition to a more inclusive and sustainable economy for 20 years. Driven by a shared belief that business and investments can play a vital role in tackling social and environmental challenges, it raised GBP 1 billion through four investment strategies (property, growth business, long term capital and outcomes contracts) and carried out 160+ investments in four impact areas (healthier lives, future skills, sustainable planet and stronger communities).

IMM GOVERNANCE

At Bridges, the first filter for every deal is impact. Potential deals are assessed for potential impact using a proprietary tool, and any deal below the minimum threshold is rejected at this first stage. These thresholds depend on the particular fund's impact themes and investment strategy in order to adapt to the specificities of each scenario.

Everyone at Bridges has a duty to deliver impact, meaning that the investment team is responsible for the operational parts of IMM while a team of two is charged with maintaining the coherence and quality of the IMM process across the funds. The latter two individuals are responsible for IMM at Bridges and work full time on creating and updating the frameworks and tools across the different funds.

Their role is not to defend impact at all costs but rather to support investment executives, working together to find the best way to tackle each problem. These two people are therefore a part of the team, a resource rather than a hurdle. The investment partner is responsible for presenting both the financial and impact sides of a potential deal to the IC, drawing upon the IMM team's expertise to help prepare the presentation and showcase each deal's potential. It is therefore the responsibility of this investment team to demonstrate that the potential investee is impactful.

Bridges has two stages of approval, during which the investment team discusses and approves each deal, before the final IC decision. Only the General Partners (GPs) are on this IC, and no Limited Partners (LPs) are present. Depending on whether there is a specific impact-related issue to discuss, one or both of the two IMM managers will usually be called in to contribute his/her expertise and opinion.

This investment team and the IMM team report to two different senior executives who both sit on the IC. This guarantees the independence of both, and gives the IMM team the opportunity to communicate directly with a member of the IC in case there is a disagreement with the investment team. This ensures that the IC receives complete information about each deal.

The IC approves not only the deal and the term sheet but also the financial and impact targets, and it also provides input on the specific metrics that will be used to track impact performance during the investment period.

These metrics are proposed by the investment team together with the investee, so that each deal is given a set of metrics to follow across the holding period, as well as a 100-day plan created for potential improvements. The impact mission is usually inscribed in the articles of the investee and would require approval of the board to be changed. As Bridges often invests majority stakes, this gives it control to block any potential mission changes that would turn an investee away from impact. Finally, although Bridges implements carried interest structures across all its funds, these are not linked to impact performance.

> We look at every investment and think about what the thesis of impact is. At every investment committee, that is part of the discussion. If it does not meet our threshold, depending on our fund (...) then we just would not do it.
>
> Antony Ross
>
> (Bridges Fund Management)

> It is the responsibility of the investment executive on each team to demonstrate, as part of their analysis, that it is an impactful business and that there is a theory of impact that we all believe in.
>
> Antony Ross
>
> (Bridges Fund Management)

Phitrust Partenaires

PHITRUST
Invest to act

Phitrust spreads IMM responsibilities across the team. It invests minority stakes and avoids mission drift by including an exit clause that is linked to impact metrics in the term sheet. It has an impact carried interest structure at the request of investors but donates the proceeds to an endowment fund that supports NGOs, furthering Phitrust's mission.

Table 4: Phitrust Partenaires Fact Sheet ↓

	Phitrust Partenaires
Typology	Venture Capital Fund
Team size	1-15
Year founded	2003
Name of founder(s)	Denis Branche and Olivier de Guerre
Location	Paris, France
Geographic activity	International (France, Europe, Asia and Africa)
Asset types/activities	Early and growth stage investments
Investment themes	Future skills, social housing, circular economy, social integration
Assets under management	< €25 million
Principles for responsible investment	Yes
Number of past investments	16
Number of funds	1

INTRODUCTION

One of the pioneering impact investors in France, Phitrust Partenaires is an investment firm dedicated to small and medium-sized for-profit enterprises with strong social impact. It provides financial and non-financial support to those enterprises, including mentoring that leverages the motivation and deep expertise of its private LPs. With a strong social mentality and expertise in social inclusion (their main impact theme), it focuses on investing in companies that tackle the problems of social exclusion and precariousness. Phitrust is also well known for its expertise in governance, allowing it to bring significant long-term value to its investees through its advice and support.

IMM GOVERNANCE

The Phitrust team first looks at impact in terms of social inclusion when evaluating a potential deal. The responsibilities of impact management and measurement are shared on an ad hoc basis across the team, based on availability and experience.

The first meeting with the IC focuses heavily on impact, specifically on making sure that impact exists and measures up to the standards of the fund. After this stage, the team starts due diligence, preparation of the term sheet and deal structuring. The investment team presents the potential deal for approval by the LPs on the IC, and the decision to invest is made through discussion between the two. These discussions are based on trust and transparency from the onset of the process, which means that surprises are rare. Although approval from the IC is required to invest, the investment team can decide to stop a process (even after the IC approved it) if they do not feel comfortable with the transaction.

Phitrust also has the particularity of having a large proportion of individual investors (around 50% of LPs), many of them keen to be involved in the decision-making process of the fund and serve as mentors to the investees. About 15 investors make up the entirety of the IC. Investors also comprise a surveillance board, which makes decisions about the future of the fund. It elects the president, validates the firm's strategy, guarantees its philosophy and mission, ensures compliance with rules and practices, and generally oversees the company's management.

Phitrust always invests a minority stake and seeks to establish a long-term relationship with the investee, supporting it for as long as possible. It usually adds a “rendez-vous” clause to re-assess the investment in five or six years and discuss the future, in order to plan Phitrust's exit while finding other actors to sustain the impact in the long term. It also includes an exit clause in case the investee's mission changes significantly. However, Phitrust works to avoid this mission drift by thoroughly assessing the founding team's motivation and commitment to impact. Phitrust always requires a board seat in order to help investees with more than just capital. They often give these board seats to LPs or mentors from their network who can bring significant value and expertise.

> “We want to generate added value, and that means going beyond funding, giving technical assistance and participating in the governance through a board seat.
>
> Danaé Becht
> (Phitrust Partenaires)

The investment team works with the investee to define a grid of impact indicators that are not too complex or expensive for the latter. The hope is for these metrics to become truly operational and strategically useful to the investee, as well as for investor reporting and monitoring. The surveillance board approves the targets following the recommendations of the investment team and the investees.

Following demands from their investors, Phitrust set up a carried interest structure based on these same impact metrics. However, the proceeds go to an endowment fund that gives grants and mentoring to NGOs instead of to the management team in order to avoid conflicts of interest when looking at firms with different economic and impact potentials. Phitrust argues that a carried interest structure would bias them in favor of deals that have lower financial and impact risk and make them shy away from potentially interesting impact-oriented deals whose financial prospects are less certain. Given the small size of the firm, annual variable remuneration is decided each year based on company and individual achievements.

Rubio Impact Ventures

Rubio has a social impact carried interest structure and an external impact advisory board to approve the impact metrics.

Table 5: Rubio Impact Ventures Fact Sheet ↓

	Rubio Impact Ventures
Typology	Venture Capital Fund Manager
Team size	1-15
Year founded	2014
Name of founder(s)	Machtelt Groothuis, Willemijn Verloop
Location	Amsterdam, Netherlands
Geographic activity	Regional (Western Europe)
Asset types/activities	Early and growth stage investments
Investment themes	Circular solutions, People power (future skills and jobs), Health and wellness
Assets under management	€150 million
Principles for responsible investment	Yes
Number of past investments	18
Number of funds	2

INTRODUCTION

Rubio Impact Ventures is based in the Netherlands and was founded in 2014. This venture capital firm provides growth capital and venture assistance for social enterprises tackling social and environmental challenges with market-based solutions. They seek to invest in environmentally friendly and social organizations based in the Netherlands. To date, they have carried out investments in circular solutions, people power and healthy living.

IMM GOVERNANCE

Rubio first checks whether the potential deal matches with their basic criteria for impact. They look for companies where the impact model and financial model are aligned so that the investment case forecast matches with the impact, reducing the risk of mission drift. To do so, they evaluate whether the impact is significantly aligned with the business model, how measurable it is, and if there are any red flags. They then do the same for the business side, and the team decides informally which deals to focus on.

> We check whether they match with our basic criteria, which is impact. First we look at whether the impact is significant, is aligned with the business model and is measurable, and then, on the higher level, whether we see any red flags.
>
> Laura Cramer (Rubio Impact Ventures)

The whole team has both commercial and impact responsibilities because they believe that the two cannot be separated and that everyone should participate in making both decisions. Everyone at Rubio is able to conduct impact analysis, and some team members help spread knowledge within the fund and build the framework used by the rest of the team.

The IC comprises the fund's five partners, while the Member Council consists of investors in the fund. The term sheet often gives Rubio a right to veto any changes to the investee's mission, which is included in its articles of association. As a basic criterion, the investee's management team has to follow the UN Global Compact standards[6]. An "impact target" document that includes the investee's 'theory of change', the main impact metrics and the targets to be achieved during the investment period is developed during due diligence. The document is then presented to and discussed with the impact advisory board before an investment decision is made. Currently, the Rubio team does everything in house, although they are considering engaging external expertise to conduct an impact audit.

> The impact advisory board consists of external people, so that it is not related to investors or management.
>
> Laura Cramer (Rubio Impact Ventures)

The impact advisory board has to approve the targets as sufficiently appropriate and ambitious before the deal can be finalized. Targets can only be changed post-deal if there is a valid reason for doing so, such as a complete business model pivot. Lagging performance would not be a valid reason. These changes are discussed during half-yearly meetings with the Member Council, where targets are reviewed and validated.

Investees upload their impact data every month so that Rubio sees actual results and can compare progress with impact targets. When evaluating the fund's overall impact performance, Rubio follows the method recommended by the European Investment Fund[7] to aggregate different impact metrics. It compares each investee's actual performance to its expected performance to calculate a percentage score and then takes the average. It therefore does not intend to define common metrics across its different investments which can be difficult to compare.

With some investments, the team can face a dilemma when exiting, as different potential buyers might imply varying financial and social returns. Rubio then has to weigh different dimensions carefully but stresses the sustainability of impact as the main driver during that decision.

Based on impact performance, the Rubio team receives impact carried interest in a binary format. This means that if the fund does not reach its impact threshold (in Rubio's case, 60% of the impact performance target), the proceeds will not be paid to the investment team and instead will be distributed to an NGO working in the same impact areas as Rubio. A 59% impact performance would therefore cancel their right to the impact carried interest.

> There is a certain hurdle percentage of return that we have to make for our investors, and if we are above that, we get a certain percentage of the return. But we only get that if we make our impact hurdle, so if we are at 59, we do not get our financial remuneration.
>
> Laura Cramer (Rubio Impact Ventures)

> The two members of the team that are prioritizing an investment would make up this list of targets together with the investee. Then they would present it to the impact advisory board, which has 100% external independent members.
>
> Laura Cramer (Rubio Impact Ventures)

6 UN Global Compact Standards: https://www.unglobalcompact.org/what-is-gc/mission/principles

7 EIF. The Social Impact Accelerator (SIA) - terms of reference: https://www.eif.org/what_we_do/equity/sia/terms-of-reference.htm

Three models

Based on our research, we have detected three main IMM governance models implemented by European impact investing fund managers, as illustrated through the case studies of Bridges Fund Management, Phitrust Partenaires and Rubio Impact Ventures (see Figure 5 and Table 2). The pros and cons of these models are summarized in Table 7.

#1 Management-driven model [Bridges Fund Management]

In what we call the management-driven model, the IMM manager is supporting the investment team as an additional resource to help them structure and carry out their impact targets. As these players are usually rather large, with various funds and sectors, the IMM team also serves to oversee and harmonize IMM frameworks across the entity. The IMM team reports to a member of the IC, and not to the investment team. Only the management team sits on the IC, as there are no external advisors or LPs involved in the decision-making process. Impact metrics are approved during the IC, along with the rest of the deal, in order to monitor the investment's evolution, flag under-performance and report to investors. Although they do have carried interest structures, these are not linked to the impact performance of the funds. They prevent mission drift through their frequent majority stakes, giving them control of the investee's board, and therefore do not include impact-related clauses in the term sheet.

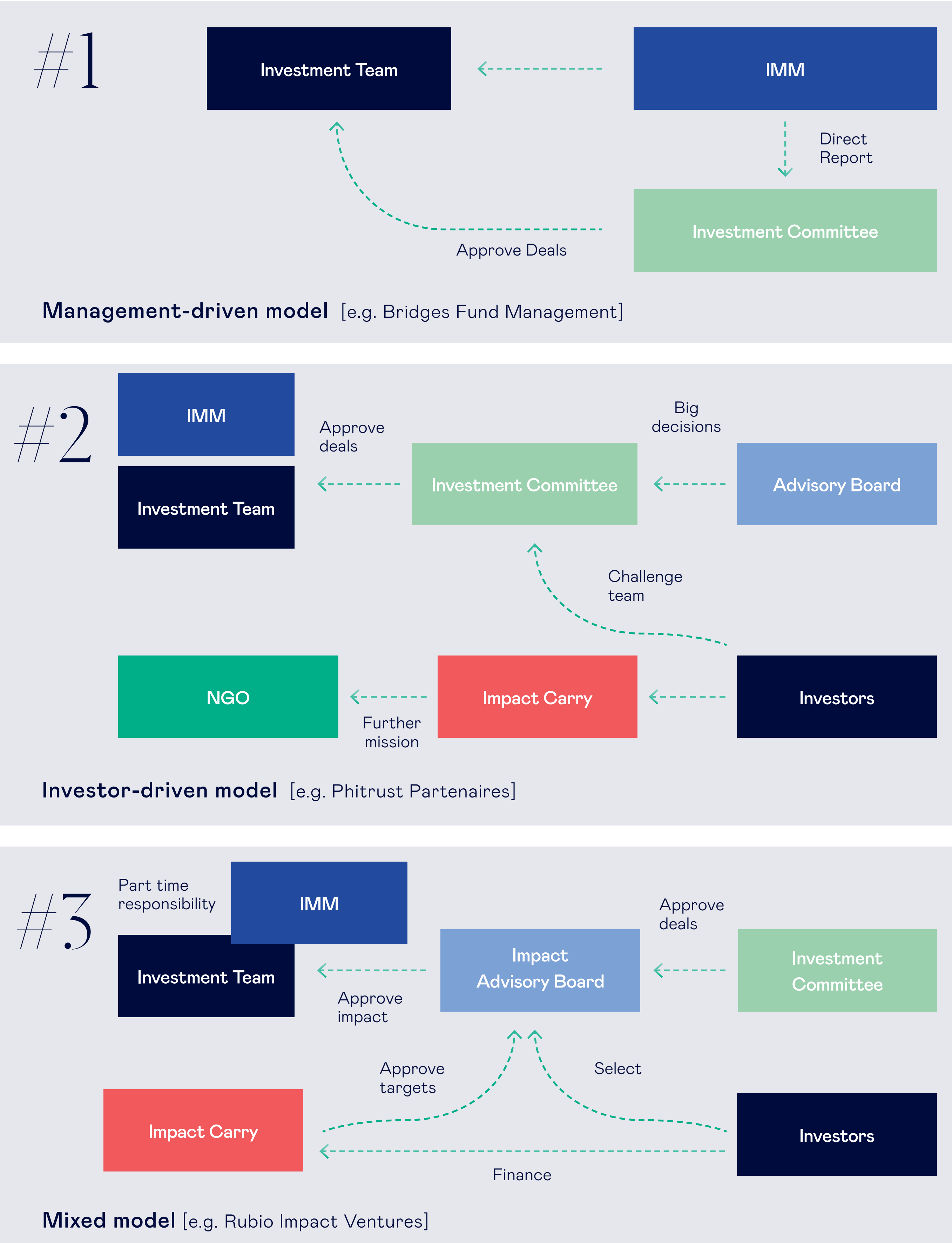
#2 Investor-driven model [Phitrust Partenaires]

The investor-driven structures are usually smaller and have more restricted resources. Impact and ESG responsibilities are therefore spread across the investment team. Specific members of the IC, which is not made up of management but rather of investors or external advisors, are tasked with challenging the investment managers on impact. Important decisions are validated by LPs. These funds usually invest minority stakes, giving them limited control over the investees. This is why they include impact metrics in the term sheet as a flagging system and precautionary measure, enabling them to exit in case of mission drift. Carried interest structures linked to impact metrics are demanded from investors but used to further the fund's mission in case of success, for example through grants or technical assistance pools.

#3 Mixed model [Rubio Impact Ventures]

Mixed model funds are in between the other two in terms of size. Impact and ESG responsibilities are spread across the investment team, although there are usually members of the team taking the lead and spreading expertise inside the fund. The IC is mostly made up of the management team, but it has to answer to external members sitting either on the IC or an external board of advisors validating the IC's decisions. Investors are represented through a supervision committee made up of investors or external experts. They follow an impact carried interest structure according to the EIF method, which goes to the investment team. An impact advisory board has to approve impact metrics, which will determine the carried interest targets. Term sheets can include a veto on changing mission or exit clause if there is a concern about mission drift.

Figure 5: IMM governance models



Source: Own elaboration

The governance models also influence how impact is integrated into the investment process. Table 6 aims to summarize how this works in the three models.

Table 6: Comparison of how three models influence the investment process ↓

MODEL	Impact filter	Investment decision	Target setting	Exit decision
MANAGEMENT-DRIVEN	Investment team discussion + IMM manager support	Fund Partners (including IMM champion)	Investment team discussion + IMM manager support	Investment team discussion + IMM manager support
INVESTOR-DRIVEN	Investment team discussion	Fund Partners + LPs (advice)	LPs	Investment team discussion
MIXED MODEL	Investment team discussion	Fund Partners + External Advisors	LPs	Investment team discussion

Pros and cons of each model

Table 7: Pros and cons of each model

	PROS	CONS
Management-driven model	· The person in charge of IMM has more time to reflect and think about how to improve it, and may be less biased. · IMM is harmonized across portfolios. · The person responsible for IMM is independent because he/she is not part of the IC. · The investment team receives constant feedback and advice on its IMM work, helping it improve its IMM capabilities. · Decision-making is simplified without inputs from other parties such as the investors.	· More expensive. · Hard to find the right person for the job, someone who understands the complexity of investment work while being knowledgeable about IMM. · No input from investors, no external checks. · The team is not remunerated based on its extra impact, and therefore receives no incentive when impact targets are met, which might be a problem during exits. · Information flows might be slower due to the size of the fund.
Investor-driven model	· Everyone on the team has the same level of IMM knowledge. · Investors have a strong influence on the decisions made and also scrutiny.	· Team members have little time to get outside training, which could bring more IMM-related knowledge into the firm, or to reflect on current processes, as this would require a full-time job. · Team members may not have the time or the resources to build sophisticated IMM.
Mixed model	· Relatively lean team where information flows quickly. · “Impact champion” that spreads knowledge inside the team and is also aware of the complexity of the job. · Incentives are aligned with an impact carried interest structure. · Impact metrics are validated externally, adding a layer of governance and transparency.	· The “impact champion” might not have sufficient time to support the entire team with each IMM related problem. · The “impact champion” has little time to get outside training, which could bring more IMM-related knowledge into the firm, or to reflect on the current processes, as this would require a full-time job.

Recommendations and Conclusions

Figure 6: IMM should be entrusted to different stakeholders at each governance level ↓

At each level of authority

1st	Pipeline level: **Investment Team** IMM should be an integral part of the mindset and process.
2nd	Portfolio level: **IMM Responsible** IMM should follow a coherent framework and quality standards throughout the fund.
3rd	Decision making level: **"Impact Champion" Partner** The IC should consider the impact dimension of each deal before investing or divesting.
4th	Vehicle level: **Impact Related Incentives** Impact should be protected at the final stages of each deal, vehicle, or remuneration package.

Source: Own elaboration

Recommendations

An overall recommendation is to ensure that IMM is entrusted to different stakeholders at each of the different levels of governance (see Figure 6).

RELATED TO GOVERNANCE

1. Whether through a dedicated staff or selected investment team members with additional responsibilities, it is important to appoint "impact champions" who will work towards improving the fund's IMM practices and standards. This also fosters accountability.

2. Aligning incentives can be done through an impact carried interest structure but also through variable remuneration incentives based on the number of deals and operational improvements, as would be the case when adhering to the IFC operating principles on impact management.

3. The IMM responsible is rarely present on the IC. But it is important that the IMM responsible has a direct route to the IC, either through an impact memorandum document or by reporting to a different higher authority than the investment team. Most ICs have, officially or not, a member focused on impact to address related questions and concerns.

4. Impact funds rarely hire external expertise for impact, because of the prohibitive cost, the present lack of suitable expertise in the market and the importance of having this core expertise in-house. Impact funds sometimes outsource the work on ESG compliance because of the potential economies of scale, as this compliance involves a lot of work and background checks and is a different competency from that of managing impact funds.

RELATED TO INVESTMENT PROCESS

5. IMM is an intrinsic part of the investment process and cannot be differentiated from the rest of the investment work. Investment teams should feel as comfortable assessing a potential deal's impact as its economic outlook.

6. Decision-making processes are most often consensus based at each stage. This ensures cohesion in small teams (such as are typical in most impact funds), where motivation and alignment are key. It also makes the process less formal and helps make sure everyone is aligned with each decision.

7. Impact is usually the first filter during the initial investment team discussion. Deals are therefore first evaluated not on the basis of potential financial returns, but on strategic fit with the fund's impact areas and potential impact performance.

8. Impact metrics are key, and set together with investees to find ones that are measurable and most appropriate. The strings attached vary, but they can become operational metrics guiding both the investees and the investment teams along their journey.

9. Mission drift is usually a main concern for funds, which they avoid by selecting socially motivated founders or finding business models with impact at the core, which would not survive if the mission were exchanged.

10. During exits, the option with the highest impact is prioritized over the financial returns, within possible limits.

Conclusion

There is no one-size-fits-all approach to IMM in impact funds. The model adopted depends on factors such as the size, experience, and mission of each fund. It is clear that funds are professionalizing and setting stricter standards for IMM governance in order to have a consistent method and rational approach.

It is very important to pick a model that fits each fund's unique resources and profile. Larger fund managers will need more help harmonizing IMM across different funds because of the number of deals, while smaller teams can spread knowledge and new ideas directly. Investment ticket size and investee size will influence the control the impact fund can exert and thus the relationship with investees. Such factors will determine the need for special clauses or safeguards against undesirable events. It is also key to cater to the investor base. Institutional investors tend to require more formal processes and structures such as a social impact carried interest structures, while private investors may trust the investment team but want to be more involved in the non-financial contribution to investees.

Additionally, there may be cultural differences which would make certain options more or less desirable for each fund. In general, formal processes send a positive message of transparency and professionalization to the market, as does consistency across deals and funds.

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