

**Responsible Investment
Forum: Tokyo
2022**

Putting your money where your mouth is

Impact-linked carry: tying incentives with impact goals.

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Based on an upcoming book chapter co-authored with
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Growing market of impact investing claims intentionality but...

72%

of LPs plan to **increase allocations** to impact/sustainability within next 2 years

- *HarbourVest 2021 survey of 130 LPs*

75%

of LPs are likely to **increase focus** on ESG or impact than before COVID-19

- *Rede Partners 2020 LP survey.*

97%

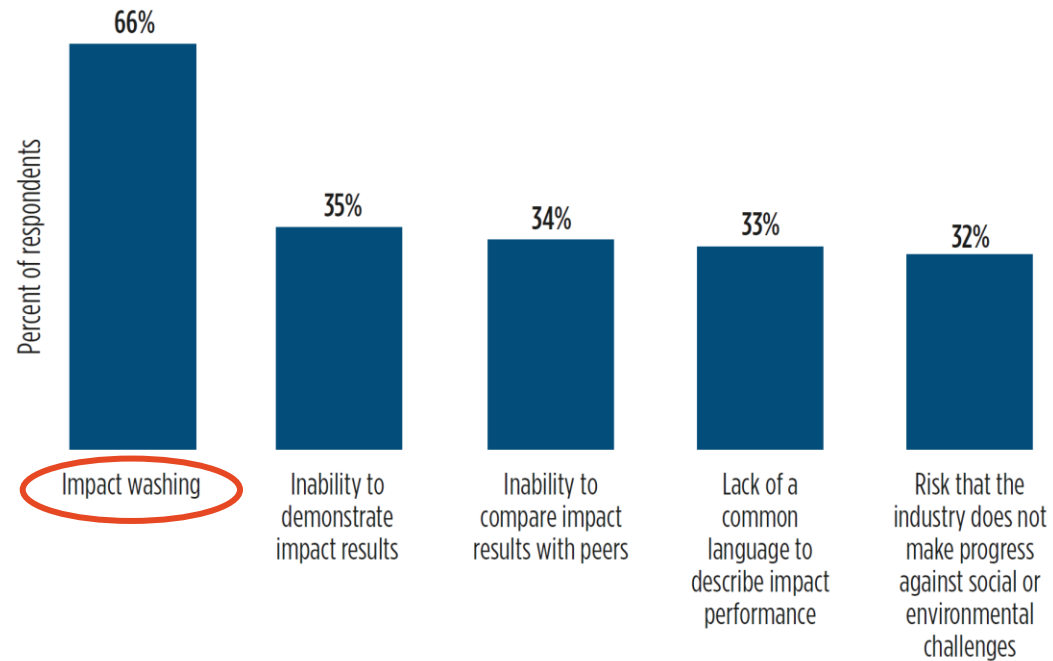
of impact investors claim that intentional pursuit of **impact** through investments is **central to their mission.**

- *GIIN 2020 Annual Impact Investor Survey*

...Impact washing is a major challenge

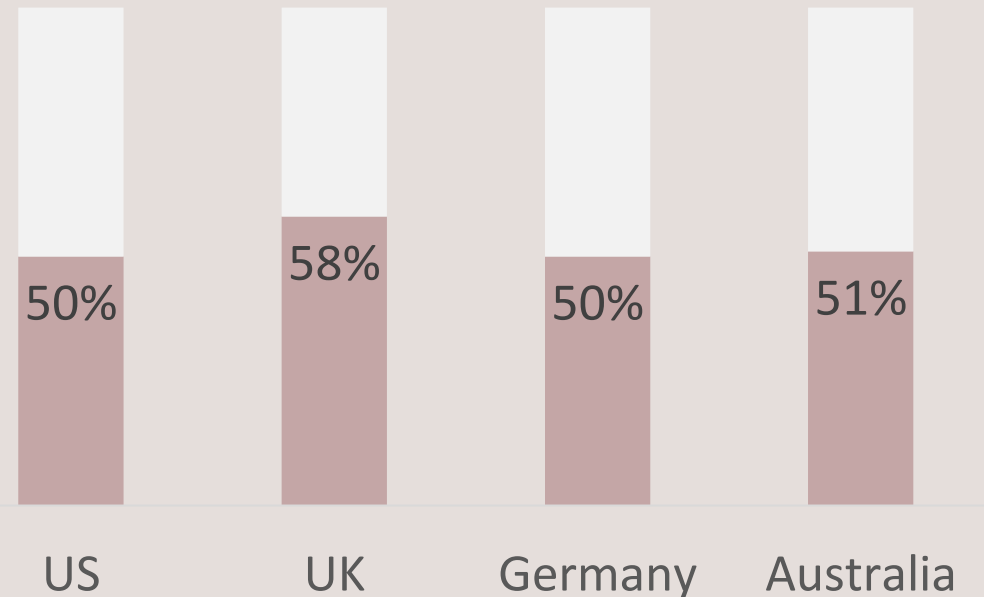
Figure 12: Greatest challenges facing the market over the next five years

n = 294



Source: [GIIN 2020 Annual Impact Investor Survey](#)

Adults who believe green washing has increased



Source: [American Century Investments: The growing appeal of impact investing – contrasting US, UK, Germany, and Australia attitudes](#)

Impact-linked carry: an incentive mechanism to advance impact

Impact investors of all types are starting to link carried interest to impact goals...

Large PE Fund groups

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Public institutions

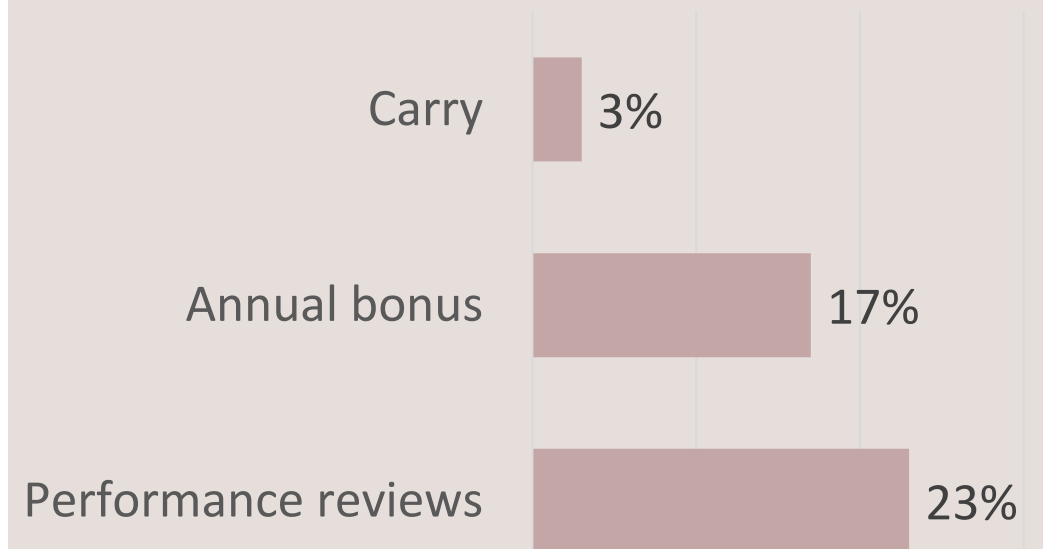


Impact investment funds

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...but it is a nascent practice with limited uptake.

% of funds aligning staff incentives with impact



Source: [Tideline: The benchmark for impact investing practice, May 2021](#)

Survey to explore the current state of impact-linked carry

Objectives:

- Find and study existing models for impact-linked carry
- Propose an open-source blueprint for practitioners

Methodology:

- 25+ semi-structured interviews
- Implementation case study

Team:

- Survey and model development: Jessica Hart, Tomas Rosales, *Harvard Business School*
- Case study: Karthik Varada, *The University of Tokyo*, Tom Schmittzehe, *Moonshot Ventures*

Full findings to be shared in an upcoming publication



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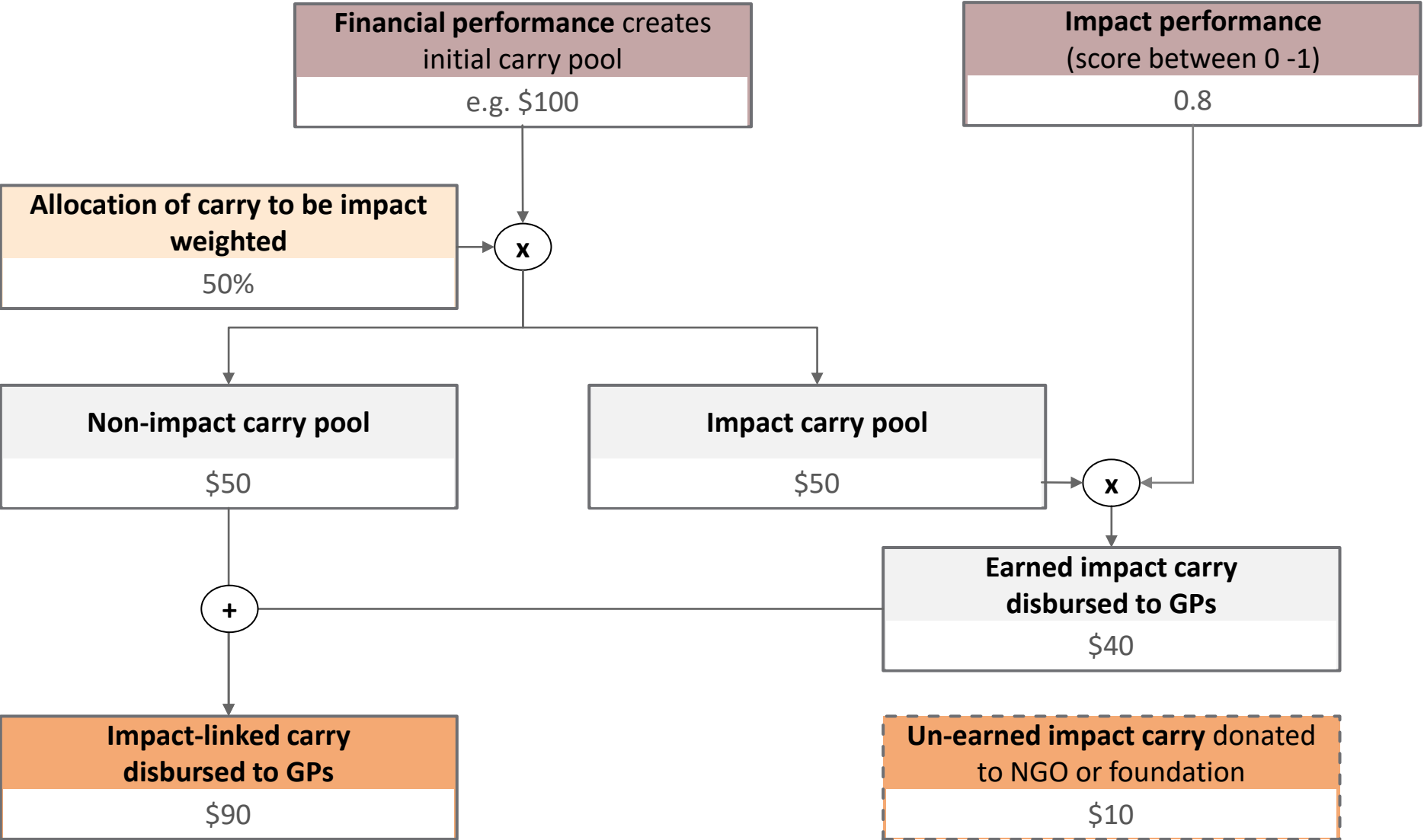
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Schematic of impact-linked carry model

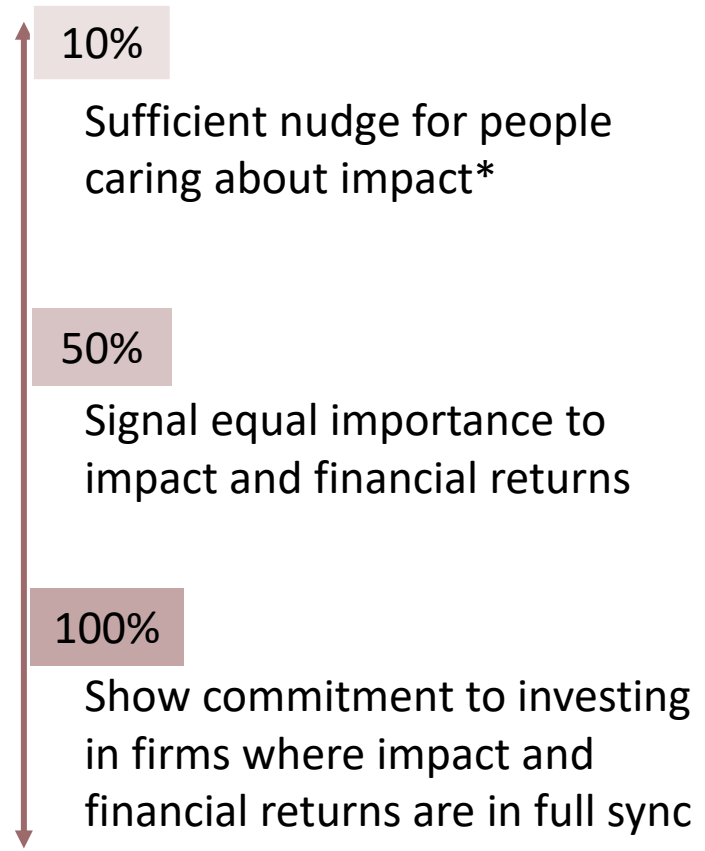


Customize the model by adjusting design choices

- 1 Share of total carry tied to impact
- 2 Fund aggregation and weighting
- 3 3rd party verification and KPI adjustment
- 4 Duration for assessing achievements
- 5 Impact carry thresholds
- 6 Managing impact upside
- 7 Distribution of non-achieved impact carry

Share of carry linked to impact tells a lot about a fund

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% of carry linked to impact sends a strong signal about a fund's motives and priorities

*These notes do not reflect the thinking of any single firm. They reflect the general sentiment among investors linking carry to impact

Aggregation helps with calculating portfolio level impact

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1. Aggregate firm level impact targets into a 0-1 score

$$\begin{aligned} \text{Firm A's impact score} &= \\ &= 50\%(\text{KPI 1}) + 30\%(\text{KPI 2}) + \\ &+ 20\%(\text{KPI 3}) \end{aligned}$$

2. Calculate portfolio impact score by

- a. weighting firm level scores with the share of capital deployed
- b. weighting firm level scores based on contribution to the carry pool

	Firm A	Firm B
Capital invested	10	10
Carry contribution	20	30
Firm impact score	1	0.8
Portfolio impact score (a)	$(1/2)*1 + (1/2)*0.8 = \mathbf{0.9}$	
Portfolio impact score (b)	$(2/5)*1 + (3/5)*0.8 = \mathbf{0.88}$	

In addition to these methods, some funds have aggregated at portfolio level based on contribution to impact goals

3rd party verification is central to tackle “impact washing”

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Key principles: keep the fund managers accountable, set ambitious impact targets, audit the results

Before: approve ex-ante impact metrics and targets before investing

During: verify adjustments to impact targets + track progress

After: audit the impact achievement at exit

Potential 3rd party options:

- Sub-committee of LPs
- Independent impact advisory committee
- Independent members of investment committee
- 3rd party professional service provider

Duration for assessment:

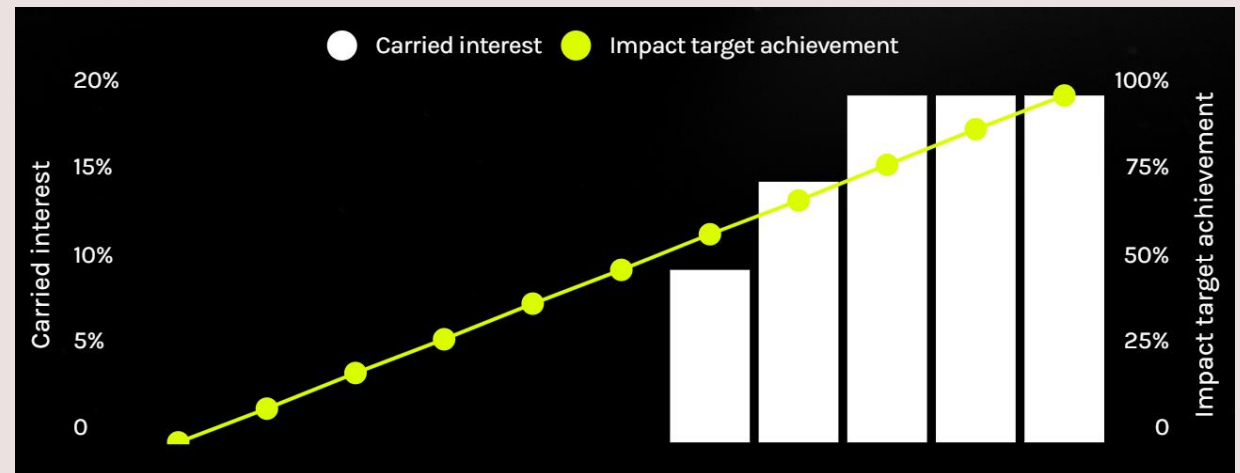
- Annual
- During exit / end of fund life

Thresholds holds investors accountable to minimum impact outcomes

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Does the fund have

- minimum hurdle rate for impact carry to be realized
- maximum threshold at which 100% or more of the carry is unlocked



Norrskan, a European impact venture fund has set a 50% impact target achievement as a hurdle rate for realizing carry. More carry is unlocked in proportion to impact created.

“Carrots” vs “sticks” to incentivize impact upside

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Adjusted stick:

- Size of carry pool fixed (usually to 20%)
- Portion of carry unlocked only when all impact goals are reached.
- Impact outperformance in one investment can compensate for underperformance in another

Carrot

- Expand the carry pool beyond the usual 20% of fund gains.
- More suited for “impact-first” investors
- Very rare phenomenon.

Distribution of non-achieved impact carry

- Donate to 3rd party NGO
- Return to impact-focused LPs offering concessionary capital
- Return to all LPs (creates skewed incentives)

Barriers for implementing impact-linked carry

Impact measurement

- While funds are starting to build better impact frameworks, few set ex-ante targets and track progress over time.

Aggregating impacts

- With portfolio firms generating different kinds of impact, fund managers find it challenging to define a portfolio-level impact score

Implementation

- It adds complexity to an already burdensome process of calculating and distributing carried interest

Buy-in from LPs

- Investors who are used to thinking of impact and carry as mutually exclusive may react negatively

Perverse incentives

- Fund managers may “game the system” through impact washing to unlock more carry

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In conclusion,

- Impact-linked carry is a powerful mechanism that aligns a fund manager's incentives with impact creation.
- If designed well, it holds the potential to tackle impact washing.
- This model is a starting point and allows fund managers to develop their own approaches for incentivizing teams toward impact.

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Thank you