



# IMPACT LINKED COMPENSATION

Considerations,  
Design Options  
and Frameworks



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# INTRODUCTION

**Impact investors are united by intentionality: the explicit pursuit of positive, measurable social and environmental impact alongside financial returns. To turn intentions into reality, funds need to understand their investments' impact on people and the planet, and then work to increase the positive effects and decrease the negative effects.**

To do this, impact investors formally integrate impact into investment processes and decision-making, portfolio management, and exits, thus setting themselves apart from traditional investors.

As the industry has developed, limited partners (LPs) and general partners (GPs) (also referred to as fund managers) focused on impact have looked for additional ways to reinforce the impact intentionality of their capital. The compensation of individuals and organizations has been routinely discussed as one option.

Impact linked compensation (ILC), a process of tying fund manager compensation to impact performance, is a tool that seeks to reinforce impact commitments through incentive alignment. ILC aligns incentives by tying a managers' financial rewards to achievement of the fund's impact goals. ILC structures have an additional benefit: they encourage funds to develop aligned impact measurement and management (IMM) practices to implement and oversee the ILC, reinforcing the link between intentionality and performance.

The Global Impact Investing Network (GIIN) released its seminal issue brief on *Impact-Linked Incentive Structures* in 2011. This brief found that well-designed and implemented impact linked compensation structures could be an effective way to motivate GPs to achieve their intended impact goals, but uptake would depend on LP demand and the willingness of GPs. Industry interest has been sustained over time: the *Stanford Social Innovation Review* published "Aligning Interests in Impact Investing" in 2013, and Transform Finance Investor Network (TFIN) released its issue brief "Tying Fund Manager Compensation to Impact Outcomes" in 2016. Yet there remains limited uptake: in Bluemark's 2023 report "Making the Mark", 31% of verified investors linked impact performance directly to financial incentives.

This limited uptake means that the vast majority of impact funds in the market still use "financial only" compensation structures. Yet, one recent study of 53 impact investment funds found that commercial terms such as hurdle, carry percentage and catch-up targets vary more in impact funds than in traditional funds (Geczy et al., 2021). It is therefore clear that impact managers and investors are making deliberate choices about the various elements of manager compensation, in ways that may already differ from mainstream funds. That the majority of impact fund managers are not being rewarded or incentivized for the impact they intend to create implies that the market sees financial success as a proxy for impact achieved. Lack of impact linked compensation suggests a misalignment between incentives and intentions.

The topic of alignment in compensation is not unique to impact investing. Nearly three-quarters of S&P 500 companies now tie executive compensation to some form of ESG performance (The Conference Board, 2022). Reward Value, a research initiative and foundation that focuses on executive pay, developed the Principles of Responsible Remuneration, which suggest compensation should reward realized long-term performance for both financial and non-financial aspects (2022). Reward Value's model of compensation has three parts: a yardstick to measure, a remuneration mechanism to link performance to pay, and governance to ensure the mechanism meets the intentions.

The initiative suggests that an appropriate yardstick is one that measures both realized and sustained performance, and that compensation models require strong governance to manage the relative nature of performance, including exploration of the extent to which stakeholders or beneficiaries should be included in the assessment of performance (Reward Value, 2022). The wrong yardstick, a poorly designed mechanism, or a lack of appropriate



governance could each create perverse incentives or “mission drift” that leads to poor impact performance (Ebrahim et al., 2014; Jones, 2016). These challenges of ILC implementation, including perverse incentives, have been addressed in most media coverage of the concept, and in a recent study by Thirion et al. (2022), which identified and described the tensions faced by fund managers who structure and implement ILC, including cost-reliability tradeoffs in impact management.

Although the impact investing field is still in the early stages of implementing ILC, the concept is increasingly represented in industry standards and regulatory guidance. Emerging standards such as the SDG Impact Standards outline requirements related to impact objectives and compensation, for example, fund managers should “align [financial] incentive mechanisms with the fund’s purpose and strategy”. Similarly, the Operating Principles for Impact Management include “aligning staff incentive systems with the achievement of impact” as a way to serve principle two: strategic impact on a portfolio basis. And in the EU, the Sustainable Finance Disclosure Regulation (SFDR) requires funds to disclose how their fund’s compensation policies are “consistent with the integration of sustainability risks”.<sup>1</sup>

The impact investing market has grown significantly since the GIIN first published its 2011 issue brief on impact-linked incentives. The latest estimates are now over US\$1 trillion in assets under management (GIIN, 2022). As the industry has grown, concerns about impact-washing have gained prominence: 66% of investors cite it as the biggest issue facing the industry in the next few years (GIIN, 2020). In the GIIN’s *Roadmap to the Future of Impact Investing* (2018), aligning manager incentives with impact is one of 18 key actions required for the impact investing industry to achieve its collective vision. The GIIN proposes that impact-linked incentives will increase both demand and accountability for impact.

## Report Objectives

Any effort or initiative to improve the impact investment discipline, including introducing ILC, should be considered in light of the field’s overarching goal: directing more capital to the achievement of more and better positive impacts.

In our summer 2023 survey of over 200 LPs, GPs and intermediaries, 51% of GP respondents reported that they had implemented ILC, with 48% of the GP respondents reporting implementation in just the last two years. Thus, readers should consider this report a collection of first-generation ILC data. While the field continues to grow and evolve, rich lessons are already emerging in planning, structuring, and implementing ILC mechanisms.

As such, this report is not a recommendation to use ILC, nor is it an assessment of best practices. Rather, this report sets out a range of considerations to help fund managers contemplate ILC in light of their unique fund structures, portfolio compositions, target impacts, relationships with asset owners, and other circumstances. The report will highlight:

- A framework for understanding the considerations that underpin the design of an impact linked compensation structure
- A spectrum of design options, illustrated by a range of examples from practice, and
- A range of future-oriented questions and considerations that LPs/GPs/the sector will need to address as impact linked compensation evolves.

## CORE DEFINITIONS

- **Impact is a change in an outcome caused by an organization. An impact can be positive or negative, intended or unintended.**
- **An outcome is the level of well-being experienced by a group of people, or the condition of the natural environment, as a result of an event or action.**
- **Impact management is the process of identifying the positive and negative impacts that an enterprise has on people and the planet, and then reducing the negative and increasing the positive.<sup>3</sup>**

<sup>2</sup> Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability related disclosures in the financial services sector” (2019) Official Journal L317, p. 10.

<sup>3</sup> <https://impactfrontiers.org/norms>



# EXECUTIVE SUMMARY

We started this research with a comprehensive literature review of the ILC space before moving into the data collection. Based on a dearth of relevant research available and the perceived consensus in the market that funds with ILC were few in number, the research team underestimated the amount of data that existed. Ultimately, the team was able to collect survey responses from 214 organizations (including GPs, LPs and intermediaries) with 52 of the GP respondents indicating that they currently used ILC in their funds and another 45 indicating they were considering building ILC into their current or future funds. Some of the key findings of the survey included:

- **How?** 74% of our GP respondents used impact linked carry with 14% using bonuses
- **Why?** Main motivations for ILC were the alignment of practices and incentives across the fund's team and the probability of improvement of realized impact from their investments
- **How?** 45% of GP respondents use bespoke metrics (bottom-up) for each portfolio company, 39% use standardized metrics across the portfolio (top-down) and 16% use a combination.
- **Verify?** 41% of GPs used third party verification.

The team chose to interview 38 of these organizations, focusing on the GPs, LPs and intermediaries who reported having already designed and implemented ILC. This selection of interviews represented a cross section of geographies, sectors and a wide variety around the size of funds, with the interviewees collectively managing \$1.9 trillion in assets.

High level takeaways from our interviews included:

- ILC should be a subset of how a fund approaches impact
- ILC should be approached with a testing and learning mindset
- Stakeholder engagement is critical at all stages of ILC
- Peer engagement and collaboration are essential for establishing best practice

Using the insights from the interviews, the team created a decision making framework for organizations looking to implement ILC. This decision making framework (next page) is relevant to all types of ILC.

## Fund Considerations

The report provides an overview of ILC using our framework that focuses on mechanism, yardstick and governance decisions. Nonetheless, we found that there are several factors and considerations that overlay all three. These include:

1. **Type of Fund:** Affects fund manager's ability to influence investments, the type of investees, return expectations, and timeframes.
2. **Size of Fund:** Determines resources available for IMM and size of potential bonus pool.
3. **Impact Objectives (Broad or Narrow):** Relates to the type of expertise needed at the governance level and choices of top-down versus bottom-up ILC approaches.
4. **Relationship between Proxies and Financial Returns:** The perceived relationship affects many dimensions of ILC design.
5. **Track Record:** Previous experience measuring and managing impact supports ILC creation and implementation.
6. **LP Alignment on Impact:** Disagreement among LPs may affect the ambition of the structure, while strong alignment could be a negotiating lever.



## Decision Making Framework

DECISIONS	FOCUS AREAS	CONSIDERATIONS
 MECHANISM	Choosing a model	<ul style="list-style-type: none"> <li>Existing financial incentives</li> <li>Who should participate</li> <li>Incentive timeline</li> </ul>
	Deciding what is at stake	<ul style="list-style-type: none"> <li>Carrot vs. stick</li> <li>All or nothing vs. sliding scale</li> <li>Amount of compensation tied to impact</li> </ul>
	Operationalizing	<ul style="list-style-type: none"> <li>Cost allocation</li> <li>Foregone compensation</li> <li>Documentation and administration</li> </ul>
 YARDSTICK	Selecting metrics	<ul style="list-style-type: none"> <li>Relevant impacts and outcomes</li> <li>Proxies</li> <li>Number of metrics</li> </ul>
	Setting targets	<ul style="list-style-type: none"> <li>Level of ambition</li> <li>Timeframe</li> <li>Level of flexibility</li> </ul>
	Getting to the portfolio level (or not!)	<ul style="list-style-type: none"> <li>Top-down vs. bottom-up</li> <li>Weighting results</li> <li>Opting out of portfolio-level integration</li> </ul>
 GOVERNANCE	Designing structures	<ul style="list-style-type: none"> <li>Oversight bodies</li> <li>Level of LP involvement</li> <li>Use of outside expertise</li> </ul>
	Assigning responsibilities	<ul style="list-style-type: none"> <li>Metrics and targets approval process</li> <li>Adjustments to metrics and targets</li> <li>Target, data and process verification</li> </ul>

## Future Research

- 1. Utility and Best Practices:** As the first generation of ILC evolves, best practices may emerge, including circumstances where ILC has the most utility.
- 2. Aligning Incentives:** Future research areas include exploring the extent to which ILC aligns incentives, experiments with incentives across multiple levels, and the impact of external motivators on intrinsic motivation.
- 3. IMM Research:** Aligned with IMM, future research could determine whether ILC strengthens the link between intentions and what is measured and achieved.
- 4. Understanding the LP Perspective:** A greater understanding of the LP perspective and a practical implementation guide for LPs are required.
- 5. Evolution and Trends:** Changes and trends in ILC will yield insights into what has worked or failed. Benchmarking ILC fund contracts against other impact contracts may provide evidence of the increased attention to governance in the structure of the fund.

# METHODOLOGY

Our research combined quantitative and qualitative data collection methods to develop a comprehensive understanding of ILC practices.

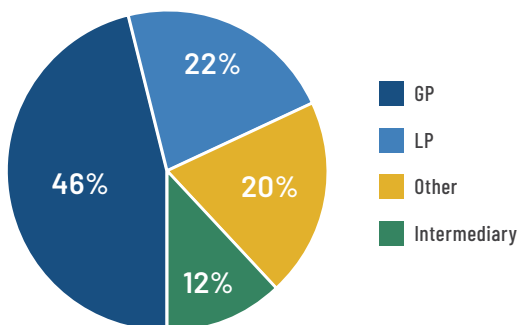
## Literature Review

The research began with a review of the literature on ILC to help inform current practices and learn from a limited set of studies conducted in the area. Based on the literature review, we developed a questionnaire that asked GPs and LPs about their ILC practices. A copy of the questionnaire is available [here](#).

## Data Collection

From the literature review and its own knowledge, the research team invited a list of relevant GPs, LPs and intermediaries to fill out the questionnaire. The questionnaire was also made available to the public to fill out over a period of eight weeks. Of 214 respondents, almost half are GPs, and 52 of the GP respondents indicated having ILC.

Fig. 1: SURVEY RESPONDENTS



*Of 214 firms surveyed, nearly half were GPs*

Of the respondents, 48 GPs and LPs with ILC expressed interest in a follow-up interview, and out of which 38 organizations were interviewed. We conducted these interviews to develop case studies and further explore current practices. Interviews were semi-structured, using an interview guide to ensure consistency across interviews.

We also invited LPs and GPs to a series of meetings to discuss how they implement ILC and to delve deeper into their decisions on governance, yardsticks, and mechanisms they use in ILC. The meetings also featured case studies, and participants

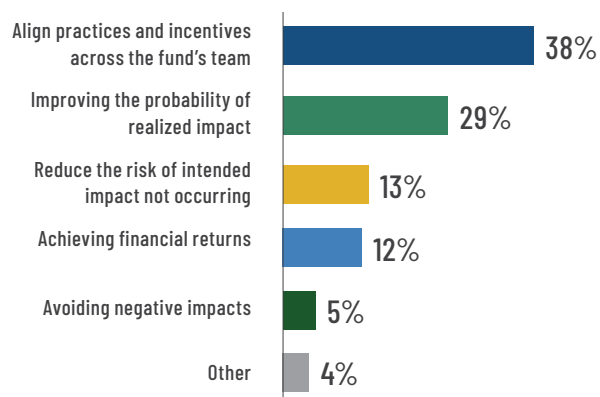
had further discussions in break-out rooms with a member of the project advisory board and a participating researcher. These meetings took place over the four months of the data collection and analysis period, and the research team used them to test out initial findings and get feedback from practitioners.

## Data Analysis

The data collected through the questionnaire and interviews was analyzed using a thematic approach that aimed to identify patterns and themes within the data. For example, 50% of the GPs who participated in the collection analysis use ILC and of those, 73% are private equity (including venture capital) funds. Of the LPs participating in the analysis, 42% have invested in vehicles that use ILC as an incentive mechanism.

Participant GPs, both with and without ILC, responded that among the main motivations to link compensation to impact are the alignment of practices and incentives across the fund's team, as well as improving the probability of realized impact from their investments.

Fig. 2: GPs MOTIVATIONS FOR LINKING IMPACT



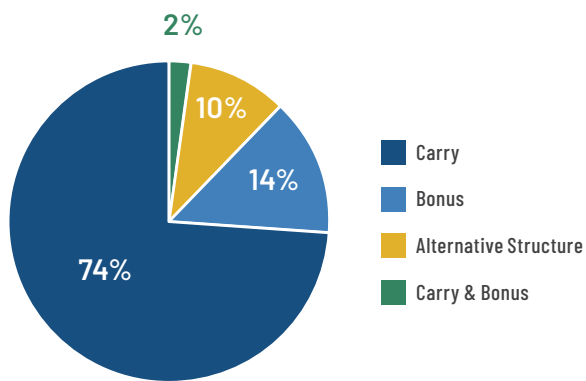
*Aligning practices and incentives were the top / foremost motivating factor*





GPs who practice ILC reported that carry is the most common mechanism, implemented by 74% of the respondents, followed by bonuses, which 14% of GPs use. Ten per cent of GPs use an alternative incentive mechanism, and only 2% use a combination of carry and bonus. The costs associated with developing and managing activities related to these incentives are mostly covered by management fees (65% of respondents), followed by a combination of management fees, resources set up in the LP agreement, and technical assistance.

**Fig. 3: HOW ARE GPs LINKING IMPACT?**



*Carry was the most common mechanism in our survey*

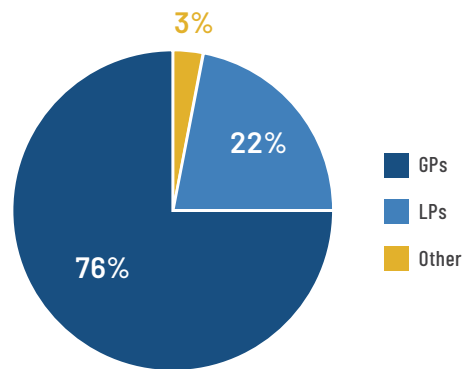
Regarding the verification of realized impact, 41% of GPs said they use some form of third-party verification. Almost half (45%) of the GPs track impact performance by choosing specific metrics for each portfolio asset, whereas 39% use standardized metrics across the entire fund. Only 16% of the GPs use a combination of specific and standardized metrics to measure impact performance.

### Interviewee Demographics

This report draws heavily on case studies developed from the interviews of 38 GPs, LPs and intermediaries. As shown in figure 4, interviews focused on GPs participants.

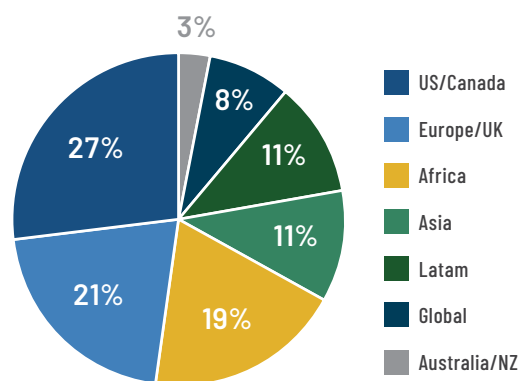
Interviews captured a wide geographic range of GP and LP experiences with the largest share of the respondents having a regional investment focus either in the US/Canada region or in Europe/UK. Nonetheless, the interviews show there is a growing trend of ILC use by both GPs and LPs with a focus in Africa and Asia.

**Fig. 4: INTERVIEW SUBJECTS**



*The majority of interviewees were GPs*

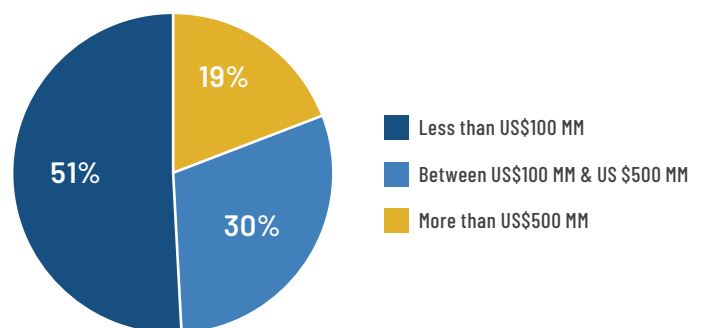
**Fig. 5: INTERVIEWEE DISTRIBUTION**



*Wide geographic spread of interviewees*

Interviewees collectively manage \$1.9 trillion in capital. Just over half of the interviewees manage less than US\$100 million in assets under management (AUM), while 19% of the sample manage over \$500 million. These figures represent the firm-level AUM and not necessarily the amount of capital managed with ILC.

**Fig. 6: INTERVIEWEES' ASSETS UNDER MANAGEMENT**



*Interviewees collectively manage \$1.9 trillion*



# KEY TAKEAWAYS

## **ILC should be a subset of how a fund approaches impact.**

ILC is a way to link and align incentive structures to the fund's impact objectives and operations. As with a fund's impact objectives, ILC should be integrated into the fund's strategy, governance structure, investment management processes and reporting.

*“ILC should be based on measures that are reflective of the fund's overall strategy and goals. In many ways it's a way to put concrete measures in place around the strategic objectives of the Fund.”*

**- Caitlin Rosser, Director Impact Management  
Calvert Impact Capital**

## **ILC should be approached with a testing and learning mindset.**

Continuous learning and improvement are vital for impact investors in order to stay effective, responsive to changing conditions, and aligned with their mission of creating social and environmental impact alongside financial returns. This approach also holds true for ILC structures. There is a notion that you have to “get it right” the first time, but there was general consensus that this is nearly impossible. The context in which funds are operating is constantly changing. Therefore, piloting, testing and developing ILC mechanisms with the ability (and resources!) to monitor, manage and adapt are essential for ILC to achieve its purpose.

## **Stakeholder engagement is critical at all stages of ILC.**

Stakeholder engagement is an essential part of developing ILC structures that are not only credible and effective but also tailored to prioritize the most significant targets and impact objectives. Stakeholders encompass LPs, GPs, investees, and other organizations and individuals with expertise relevant to the fund's objectives. A particularly important stakeholder group includes those who bear the ultimate impact of investees and investments, particularly in the context of social and environmental impacts. These ‘end-stakeholders’ must be actively consulted to articulate their perspectives on the most vital social outcomes and thereby inform the design of the ILC structure. This engagement should persist with ongoing social and environmental performance measurement, emphasizing a commitment to avoid potentially misleading proxies, in accordance with evolving impact reporting standards.<sup>4</sup>

## **Peer engagement and collaboration are essential for establishing best practice.**

ILC models are a relatively new practice, particularly in the alternative asset management space. Our report highlights the value of undertaking ILC with a collaborative and knowledge-sharing approach. This approach should include knowledge-sharing between GPs and LPs and across funds and others in the impact ecosystem. Much of the feedback gathered during this project noted the value of speaking to other fund managers on a similar journey. Because examples to learn from are limited, opportunities to speak to others have enabled fund managers to pose key questions about similar barriers they may have faced, and how to avoid these.

<sup>4</sup> For more on this please see: [https://impactfrontiers.org/wp-content/uploads/2023/10/Exposure-Draft\\_Impact-Performance-Reporting-Norms\\_Public-Consultation.pdf](https://impactfrontiers.org/wp-content/uploads/2023/10/Exposure-Draft_Impact-Performance-Reporting-Norms_Public-Consultation.pdf)

# EXPLORING IMPACT LINKED COMPENSATION OPTIONS

Within impact investing, each level of fund activity warrants a different kind of compensation. This can exist between asset owners and asset managers in the form of carry, or within organizations in the form of bonuses (individual and portfolio based) or performance evaluations. This section reviews each of these options.

Table 1: **IMPACT LINKED COMPENSATION OPTIONS**

LEVEL	COMPENSATION
Between asset owners and asset managers	<ul style="list-style-type: none"> <li>• Carry</li> </ul>
Within organizations (asset owners, asset managers or portfolio companies)	<ul style="list-style-type: none"> <li>• Bonus based on portfolio performance</li> <li>• Bonus based on individual performance</li> <li>• Performance evaluation</li> </ul>

## Compensation between asset owners and asset managers

In private equity and venture capital, carried interest (carry) is part of the standard 2/20 fund management fee structure, in which the 2 represents the average 2% management fee, paid annually on AUM and the 20 represents a 20% share of the profits of the fund that a fund manager receives after certain financial targets (also called hurdles) are met.

Impact-linked carry integrates impact targets into the calculation of carried interest. Impact-linked carry was the dominant mechanism in our data, with 76% of respondents that have implemented ILC using it alone or in conjunction with other models. As discussed in our methodology section, this reflects the dominance of private equity and venture capital funds in our sample. Within this universe, the use of impact-linked carry was reported across fund sizes and among generalist and specialist funds.

Carry is a long-term incentive with payouts at exit (of investments and/or of the fund). Traditionally, senior team members are the ones financially rewarded through carry, but funds can make choices about who is rewarded via carry, including junior team members.

## VOX CAPITAL: CARRY

Vox Capital, a US\$200 million fund with investments in Brazil, links impact performance to carry. Vox Capital uses a traditional waterfall compensation structure, but half of the carry is tied to impact performance. If the fund achieves its impact target, Vox earns all of the carry, but if the fund is below the impact performance threshold, it forfeits half of the carry (carry at risk). In the interview, Vox Capital reps explained that they believed “we were claiming to really be an impact investor who had these inner principles..., [but] to claim to be an impact investor, you must have some impact linked compensation.” Carry was the traditional VC model of compensation, so they married their inner principle of impact-led investment with traditional waterfalls to create their ILC.

## Compensation Within Organizations

Within our research, we found that compensation within organizations can take one of three forms: (1) bonus based on portfolio performance, (2) bonus based on individual performance, and (3) performance evaluations. These forms hold true for asset managers, asset owners and portfolio companies, but the scope of our research meant asset managers are the focus of this report. As is mentioned in the future research section of this report, we believe there is significant scope to collect additional data for analysis in this area.



### **Bonus linked to portfolio impact targets**

With bonuses based on portfolio impact targets, the achievement and calculation of bonuses are based on overall portfolio impact performance.

#### **CALVERT IMPACT: BONUS BASED ON PORTFOLIO PERFORMANCE**

In 2023, Calvert Impact, a nonprofit impact investing firm established in 1995 with over \$500 million under management, launched a new bonus component to its compensation structure through its core debt portfolio. The compensation committee of the company's board of directors oversees the bonus pool allocation and distribution. Calvert Impact's bonus pool is based on the achievement of organization-wide goals set at the beginning of the year. These goals now include an impact goal based on its internal impact scorecard, which has a strong emphasis on whether Calvert Impact's capital was additional.

### **Bonus linked to individual targets**

With bonuses based on individual performance, impact performance is a component of a team member's individual evaluation and compensation. Such a bonus structure includes clear impact targets defined for individual staff members (related to performance and/or process) and is directly related to the achievement of these targets.

#### **NUVEEN: BONUS BASED ON INDIVIDUAL PERFORMANCE**

Nuveen's Private Equity Impact team, as part of its annual review, considers social and environmental goals as part of the annual ratings process. Most employees have a base salary and variable compensation based in part on individual performance. Employees receive a rating on a five-point scale based on their ability to achieve certain goals, set at the beginning of each year with their managers. For several years, every employee on the Impact team has had a goal related to the impact process (for example, ensuring consistent application of diligence templates) and/or performance (such as obtaining specific environmental outcomes).

These structures can unlock additional compensation for senior as well as junior staff. Of the funds we surveyed, 16% use bonus alone or in combination with other ILC models. With a bonus structure, funds have flexibility in implementing near- or far-term incentives for impact performance.

### **Performance evaluations**

Fund managers can also link impact to performance-evaluations more generally. In this case, an individual's performance score or eligibility for promotion would be tied to impact achieved. Performance evaluations create near-term incentives with annual periods of review.

Within performance evaluations, staff are typically asked in annual reviews about what they did that related to impact and how they engaged actively on impact as it relates to investment strategy. This type of evaluation could be done for impact professionals as well as for investment teams.

#### **LEAPFROG INVESTMENTS: PERFORMANCE EVALUATION AND AN ANNUAL BONUS**

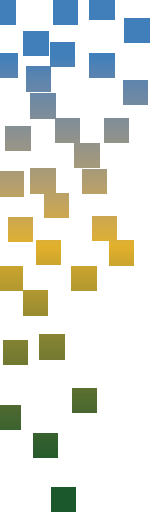
LeapFrog Investments is a fund manager with over US\$1B AUM that invests in high-growth financial services, healthcare and climate solutions companies in emerging markets. It has an impact-linked performance evaluation framework that operates at both the individual and firm-wide. Firstly, individual annual bonuses for eligible staff members are connected to the achievement of certain impact KPIs. Progress against these KPIs is evaluated annually and formally factored into performance reviews. Each year, LeapFrog also selects firm-wide impact KPIs, and performance against these firm-wide impact KPIs influences the size of the leadership bonus pool. These KPIs are based on both impact management (e.g., rolling out robust impact monitoring frameworks for portfolio companies or building public impact insight indices) and impact performance (e.g., KPIs such as the number of emerging consumers reached).



This research covered compensation linked to impact, but this does not include all financial incentives linked to impact within impact investing. There is a significant amount of research around impact incentives, because financing models that tie interest payments or capital repayment to impact performance have existed in the impact investing and sustainable finance space for years.

Sustainability-linked loans (SLLs) and bonds (SLBs), which link sustainability targets to the cost of capital for the issuer, are now some of the fastest growing financial instruments in the world. As of July 2023, there have been over US\$250 billion in cumulative issuances. We believe that SLLs and SLBs have many overlapping considerations with ILC for alternative asset funds and have noted some of these connections in this report.

On the private capital side, impact-linked finance is also a growing field in which funders tie impact targets to outcome payments, the cost of debt and/or principal repayments. Unlike SLLs and SLBs, these contracts can include a third party willing to make additional payment for the achievement of impact.



# DECISION-MAKING FRAMEWORK



One of the key concerns about ILC is its complexity. The majority of our survey respondents cited this reason for not implementing ILC; many noted they didn't know where to start. In this section, we attempt to break down the decisions required to implement ILC into three categories: mechanism, yardstick and governance. This framework comes from Reward Value's work, whose design considerations include selecting a mechanism to link performance to pay, choosing the appropriate yardstick to measure performance, and designing fit-for-purpose governance.<sup>5</sup>

Within each of these decisions, we identify the important areas to focus on in order to create a systematic approach to decision-making.

We then discuss key considerations for making appropriate decisions. We use case studies to illustrate how different fund managers have approached decision-making and design based on these considerations.


It is important to note this is not a linear framework. The decisions required for design and implementation of ILC are interrelated and require an iterative learning process, as we note above. Nonetheless, we are cautiously confident that we have created in these pages a fulsome resource for diligently thinking through the design of ILC.

Table 2: **DECISION-MAKING FRAMEWORK FOR THE DESIGN AND IMPLEMENTATION OF ILC**

DECISIONS	FOCUS AREAS	CONSIDERATIONS
 <b>MECHANISM</b>	<b>Choosing a model</b>	<ul style="list-style-type: none"> <li>Existing vs. new financial incentives</li> <li>Who should participate</li> <li>Incentive timeline</li> </ul>
	<b>Deciding what is at stake</b>	<ul style="list-style-type: none"> <li>Carrot vs. stick</li> <li>All or nothing vs. sliding scale</li> <li>Amount of compensation tied to impact</li> </ul>
	<b>Operationalizing</b>	<ul style="list-style-type: none"> <li>Cost allocation</li> <li>Foregone compensation</li> <li>Documentation and administration</li> </ul>
 <b>YARDSTICK</b>	<b>Selecting metrics</b>	<ul style="list-style-type: none"> <li>Relevant impacts and outcomes</li> <li>Proxies</li> <li>Number of metrics</li> </ul>
	<b>Setting targets</b>	<ul style="list-style-type: none"> <li>Level of ambition</li> <li>Timeframe</li> <li>Level of flexibility</li> </ul>
	<b>Getting to the portfolio level (or not!)</b>	<ul style="list-style-type: none"> <li>Top-down vs. bottom-up</li> <li>Weighting results</li> <li>Opting out of portfolio-level aggregation</li> </ul>

<sup>5</sup> Reward Value is a non-profit that works with investors, universities and business to modernize executive pay as a catalyst for positive change.



DECISIONS	FOCUS AREAS	CONSIDERATIONS
 <b>GOVERNANCE</b>	<b>Designing structures</b>	<ul style="list-style-type: none"> <li>• Oversight bodies</li> <li>• Level of LP involvement</li> <li>• Use of outside expertise</li> </ul>
	<b>Assigning responsibilities</b>	<ul style="list-style-type: none"> <li>• Metrics and targets approval process</li> <li>• Adjustments to metrics and targets</li> <li>• Target, data and process verification</li> </ul>



## MECHANISM DECISIONS

The reason for implementing ILC most cited by our survey respondents and interviewees is aligning practices and incentives. Our research shows there is early anecdotal evidence that ILC does just that – focus attention on how impact considerations are integrated across investment practices. In order to do so, our respondents stressed the need for ILC to be fit for purpose. Decisions for the ILC mechanism are central to designing models that are appropriate and effective.

In this section, we break down the mechanism decisions into three focus areas: choosing a model, deciding what is at stake, and operationalizing ILC. Within each of these we explore three key considerations:

Table 3: **MECHANISM DECISIONS**

MECHANISM DECISIONS		
Choosing a model	Deciding what is at stake	Operationalizing
Existing vs new financial incentives	Carrot vs. stick	Cost allocation
Who should participate	All or nothing versus sliding scale	Foregone compensation
Incentive timeline	Amount of compensation tied to impact	Documentation and administration

### Choosing a Model

As discussed above, there are several ways to link compensation to impact, including carry, bonus and performance evaluation. At this stage in ILC development, there is no wrong model, but in our research we identified existing financial incentives of the fund, who should participate, and the timeline for ILC incentives as key considerations when making mechanism decisions.



MECHANISM DECISIONS
Choosing a model
Existing vs. new financial incentives
Who should participate
Incentive timeline

### Existing vs. new financial incentives

ILC can embed impact into existing financial incentives or create new financial incentives linked exclusively to impact. The fund’s organizational structure and its existing financial incentives inform ILC decisions. For example, many private market funds in our sample that use a range of strategies (equity, debt, and mezzanine) and real asset funds used impact linked carry. (For more on how different aspects of funds (size, asset type, etc.) feed into ILC decisions, see the [Fund-Level Considerations](#) at the back of this report. Some of these funds also incorporated impact-linked bonuses as a standalone approach or in conjunction with impact-linked carry. Existing financial incentives within the fund help guide an organization to the appropriate starting point for ILC.

*“Carry is the standard for aligning incentives between LPs and investment teams. In 2013, as an impact investment fund we felt that we had to find a compensation mechanism that captured both financial returns and impact, with a carry 100% generated by the financial performance and 100% constrained by the social impact. Carry seemed like the right instrument as it’s a compensation mechanism for the team, and it’s a tool that LPs already understand well.”*

**- Yannis Lambourdière**  
Director, Investor Relations Impact Partners

### Who should participate

Answering whose impact performance should be rewarded financially is a key consideration when designing an ILC model.

Different ILC models incentivize different actors. Impact-linked carry directly rewards fund managers for impact performance. While adopters of impact-linked carry cite the trickle-down effects of impact-linked carry throughout the fund, in many funds, only senior level team members reap the financial rewards.

**One participant noted that impact-linked**  
*“...carry creates an incentive for the fund, [but] that fund-level incentive doesn’t necessarily always reach the investment team.... In [our] case, the team didn’t necessarily feel that pressure on them as much.”*

With bonus and performance evaluations, a broader range of team members can participate in financial incentives at the fund, and even within portfolio companies.

### Incentive timeline

Each ILC model – carry, bonuses, and performance evaluations – has a different incentive timeline. Impact-linked carry offers a long-term incentive for fund managers at exit from portfolio companies. Long-term incentives help managers plan for the future, but they also delay rewards on progress made in the near term. Performance evaluations at the fund or portfolio company level do the opposite, because they typically focus on annual performance metrics and the incremental steps to long-term impact. Bonuses offer flexible timing with the option of annual bonuses, much like performance evaluations, or incentives to hit certain benchmarks at the 3-, 5- or 7-year windows.

Existing financial incentives, who should be incentivized by ILC and when to unlock those incentives are crucial inputs to selecting the appropriate impact linked compensation model for a given fund.





As Santiago Alvarez, Managing Partner at ALIVE Ventures, said,

*“If you think about fund structures, where you require a long-term alignment ... we believe carry is where you get the alignment in terms of sourcing, investing, management of our portfolio, and then also exiting. All other incentive structures are more short term.”*

MECHANISM DECISIONS
Deciding what is at stake
Carrot vs. stick
All or nothing vs. sliding scale
Amount of compensation tied to impact

### Deciding what is at stake

In this section, we'll look at using impact performance as a carrot or a stick, using an all-or-nothing approach versus a sliding scale, and the amount of compensation tied to impact.

#### Carrot vs. stick

Technically, ILC can be designed to unlock additional compensation or to forfeit a portion of compensation if impact targets are not met. This concept applies to carry, bonus, and performance evaluations, but realistically looks quite different for each of these types of mechanisms.

One of the debates in impact-linked carry has been whether impact achievement results in additional carry beyond the traditional 20% profit that LPs share with fund managers. Some fund managers have argued that they should be rewarded beyond the traditional financial terms for additional impact created. According to our survey responses, 69% of LPs do see ILC as a carrot – a good tool for inducing impact performance. Yet carry at risk was the most common form of mechanism in our data, meaning the majority of carry mechanisms observed in this research were structured so a portion of GP carry would be forfeited if impact targets were not achieved. This implies that fund managers are structuring their carry calculation in a way that integrates impact into the traditional 20% profit share.

There are three macro trends that are likely relevant to this discussion. Firstly, fees for all active fund managers are under significant pressure from asset owners. Secondly, the impact fund managers in our survey market their funds as “market rate return” impact funds, often explicitly stating that their ability to create market rate returns relies on their unique impact thesis. Thirdly, the recent growth of the impact investing market has largely been driven by “market rate-seeking” LPs, including large institutional investors, that are attracted by the idea of not sacrificing financial returns for social impact. Together these trends make it difficult for “market rate” impact funds to convince “market rate” LPs to pay additional fees for impact created.

#### GAWA CAPITAL: CARRY AT RISK

GAWA Capital, a €200 million fund based in Madrid, invests only in emerging markets with the goal of transforming lives in vulnerable communities. GAWA uses carry as its ILC mechanism and follows a typical 2-and-20 model with half of the 20% carry linked to impact performance. The base carry is 10% and is conditional on financial performance (meeting the financial return hurdle rate). Additional carry is based on the impact score of the investment at the time of exit. The impact score is based on a scale of 0-10 and represents the additional carry available. For example, an impact score of 3 is added to the 10% carry to create an 87/13 split, whereas a score of 8 bumps carry up to 18%.

Notwithstanding the trends discussed above, we did see a couple of examples in our data of LPs who were willing to offer additional fees beyond the traditional 20% carry for impact achievement. These LPs tended to be “impact first” in their priorities and thus willing to trade financial returns for additional impact created.



### **SWEEF CAPITAL: ADDITIONAL CARRY TO FACILITATE TECHNICAL ASSISTANCE**

Sweef Capital, a \$43 million fund based in Singapore, invests in EBITDA-positive growth businesses across Southeast Asia in health-care, education, sustainable foods and climate resilience that demonstrate a clear commitment to gender equality in their leadership, operations, and value chains. To enhance gender impact outcomes, Sweef aligns impact targets to its carry structure. Beyond financial gains, its investors expressed a keen interest in promoting technical assistance activities to bolster Sweef's Capital's Gender ROI™ thought leadership in the industry. In pursuit of this goal, Sweef has integrated five impact targets into its compensation mechanism, with some focused on gender targets and others on ecosystem building and climate integration. Failure to meet these targets results in a forfeiture of carry; successful attainment allows Sweef to surpass the standard 20% carry it would have earned. Depending on the achievements, Sweef can earn between 18.5% and 33% based on the targets fulfilled.

As noted in the *Exploring ILC Options* section, linking bonuses to impact performance can be done in any organization (within LPs, GPs or portfolio companies). In theory, bonus structures can also be used as a carrot or a stick, but in reality they tend to be more aligned with putting bonus at risk (stick). Bonus pools are typically contingent on financial performance of the organization, thereby making it hard to compensate for impact performance separate from financial performance. The majority of bonus structures we reviewed integrated added impact considerations to existing bonus compensation structures, but based on a fixed pool determined by financial performance.<sup>6</sup>

### **BRITISH INTERNATIONAL INVESTMENT (BII): INTEGRATING IMPACT INTO BONUS STRUCTURES**

BII has developed a portfolio-level impact tool called the Impact Score that quantitatively assesses impact aligned with BII's strategy, across all investments. Aligned with the

roll-out of this tool, BII modified its Long-Term Incentive Performance Plan (LTIPP) to integrate the portfolio-level impact score. The LTIPP is now based on three components: (1) financial return of the total portfolio; (2) development impact of the portfolio based on the portfolio Impact Score; and (3) corporate objectives score.

Of the performance evaluations we reviewed, we typically noted that impact considerations were integrated into existing evaluation processes, serving as an integrated approach to incentivizing and holding staff accountable to individual and/or broader impact-related objectives.

### **All or nothing vs. sliding scale**

Funds should also determine whether the achievement of impact targets unlocks full compensation tied to impact (effectively all or nothing) or should reward progress if full attainment isn't achieved.

Vox Capital, featured above, uses an all-or-nothing approach to carry. Once financial returns are met, impact performance "gates" the impact-linked carry. When the fund achieves the impact target, it unlocks the 50% of carry that is at risk for the managers.

Sliding scale approaches account for incremental or relative progress against a goal(s). In general, we saw two different approaches to sliding-scale structures. The first is an impact range approach, where a range of impact performance is defined with a set range of carry received.

### **SHIP2B VENTURES' B SOCIAL IMPACT FUND: SLIDING SCALE WITH AN IMPACT RANGE**

The B Social Impact Fund is a €55 million fund with a primary geographic target in Spain and 100% of its carry at risk, after meeting its financial hurdle. The fund is managed by Ship2B Ventures. If the fund fails to achieve 60% of its impact targets, then all carry is forfeited. If the fund achieves 80% or more of its impact target, then the whole carry is unlocked. Impact performance between 60 and 80% of impact targets earns a sliding-scale carry.

<sup>6</sup> The scope of this research did not dive into the detailed mechanism of bonus structures, but this is an area we have identified for future research studies.



The second approach is a sliding scale based on relative performance. This is where the percentage of the goal achieved is equivalent to the percentage of carry at risk achieved.

#### **CIRCULATE CAPITAL: SLIDING SCALE WITH RELATIVE PERFORMANCE**

Circulate Capital, a specialist fund invested in the plastics supply chain, has a sliding-scale model based on relative performance. The fund's impact target of preventing plastic pollution is based on the total fund size. The fund starts to qualify for payments at 25% of the target (anything less than that and the payment is forfeited). Additional plastic pollution prevented above the 25% target earns additional payments until the full target is met and the full payment made, with payments increasing in 1.75% increments.

*“Once we hit the target, then 100% of [the payment] was released. The sliding scale was important because if we get halfway there, then we still should get 50% of the carry that’s being held in escrow, because it wasn’t a complete failure.”*

**- Rob Kaplan, CEO, Circulate Capital**

Our carry data to date contains examples of both approaches, with slightly more frequent use of all or nothing than sliding scales. All-or-nothing approaches to carry are likely dominant because they mirror the classic waterfall compensation structures in traditional finance. Both funds and investors are familiar with the all or nothing approach in traditional funds. The all or nothing approach also offers funds simplicity for drafting, implementing, monitoring, and awarding the ILC. Of the bonus examples we examined, many followed a sliding-scale approach.

#### **Amount of compensation tied to impact**

Funds must set the amount of compensation tied to impact. Funds in our sample reported a wide range of carry mechanisms, from 5% to 100% of the chosen compensation model, with 50% as the median amount. We had fewer examples of bonus in our sample, but some models included 50% of

a bonus pool tied to impact, and another featured impact as one of five bonus pool considerations.

#### **IMPACT PARTNERS: 100%**

Impact Partners is a €340 million fund that invests in social businesses across Europe. Impact Partners uses carry as its ILC structure once the financial hurdle, which is a 7% net internal rate of return (IRR), is reached. 100% of that carry is linked to impact performance. For each portfolio company, an impact target is defined. At exit, the ratio between the realized performance and the target is the impact performance of the assets. The average impact performance of the portfolio, weighted by the amount invested, results in the impact performance of the portfolio. If the portfolio's impact performance is below the impact hurdle, which is 60%, all the carry is given to NGOs. If the impact performance is above the impact hurdle, the carry is split pro rata between the team and NGOs.

#### **DEVELOPING WORLD MARKETS: 75%**

Developing World Markets (DWM) is a US\$550 million impact investment fund manager raising a US\$75 million fund focused on forcibly displaced communities. DWM invests in companies that are addressing societal needs in underserved regions such as Latin America, Africa and the Middle East. DWM will use carry in its ILC structure once the financial hurdle is reached. Of that carry, 75% is linked to impact performance in three equally weighted metrics of DWM's portfolio companies: refugees served, women served, and income growth of internally displaced persons.

#### **DRAWDOWN FUND: 50%**

The Drawdown Fund, a US\$250 million fund based in Utah, US, invests in catalytic growth equity businesses that address the major drivers of climate change. Its investments target sustainable cities, food and agriculture, and energy. The Drawdown Fund uses carry as its ILC structure once the financial hurdle is reached. Half of that carry is linked to impact performance. If its portfolio companies achieve certain emissions objectives (reduction or sequestration), then the carry is delivered to the Drawdown Fund.



### NEW FORESTS: 20%

New Forests, a A\$11 billion investment manager headquartered in Sydney, Australia, invests in sustainable timber plantations and conservation areas, carbon and conservation finance projects, agriculture, timber processing and infrastructure. In its first Africa fund, the Africa Forestry Impact Platform (AFIP), a US\$500 million (targeted) open-ended vehicle focused on forestry investments in Sub-Saharan Africa, NF uses carry as its ILC structure once the financial hurdle is reached. Of that carry, 20% is linked to the delivery of positive impact outcomes across the four themes of climate, biodiversity, gender, and community and livelihoods.

MECHANISM DECISIONS
Operationalizing
Cost allocation
Foregone compensation
Documentation and administration

### Operationalizing

In this section, we cover some of the operational decisions required when setting up an ILC mechanism. These include allocating costs, deciding what happens to foregone compensation, and documenting and administering ILC.

### Cost allocation

Despite the strong belief from the sample that impact and financial performance go hand in hand, measuring and overseeing impact performance undoubtedly cost funds time and money, so one of the most common questions is, “who pays?” Respondents typically funded ILC yardstick and governance through management fees, although we did encounter several outliers who used technical assistance to help fund the impact measurement and management (IMM) associated with their ILC.

### GAWA CAPITAL: AMPLIFYING IMPACT USING TECHNICAL ASSISTANCE

GAWA Capital’s investment funds are dedicated to catalyzing positive transformation

in vulnerable communities in emerging markets. This mission is achieved primarily through strategic investments in companies like microfinance financial institutions, credit cooperatives, fintech companies, and leasing organizations. To further its transformative objectives, GAWA Capital uses a technical assistance facility to enhance the products, processes, and capabilities of its portfolio companies. Technical assistance can be deployed to develop and launch specialized products tailored, for example, to smallholder farmers, as well as robust risk management systems that equip smallholder farmers to withstand challenges like climate events and natural disasters.

### ALIVE VENTURES: USING TECHNICAL ASSISTANCE TO DEEPEN IMPACT MEASUREMENT ACTIVITIES

ALIVE Ventures, an impact investment fund manager with US\$71 million in AUM, invests in companies that use technology and other innovations to address income inequality in Latin America and uses technical assistance to undertake more rigorous impact measurement activities of key demographics, such as exploring gender inclusion in underserved populations. The technical assistance facility allocates resources that support impact measurement studies and gender-related assessments. The findings from these studies play a vital role in evaluating the impact of each portfolio investment. These studies are not used for meeting predefined performance criteria; instead, they serve as essential inputs for the comprehensive evaluation of portfolio companies’ overall impact.

### Foregone compensation

Another logistical concern involves what to do with unearned ILC money, whether carry or an unearned bonus pool. In the event that carry is earned and held in escrow but not unlocked for managers because of subpar impact performance, who gets the money? In the funds that participated in our research the unearned carry at risk either goes back to the LPs or can be distributed to another organization that can achieve related impact outcomes. Similar approaches can be used with unearned impact bonus pools.



### **GAWA CAPITAL: FORFEITURE TO INVESTORS**

GAWA Capital employs a flexible fee structure that prioritizes the financial interests of its investors if impact is not attained. Specifically, 10% of its carried interest is linked to its impact performance, assessed on a 10-point scale. Investors are guaranteed a minimum of 80% of the total carried interest. In the event that the fund's impact score falls below a certain threshold, GAWA Capital allocates more of the carried interest to its investors.

For instance, if GAWA Capital achieves a score of three on its impact assessment, it will receive only 3% of its allocated impact portion, alongside the 10% financial carried interest. This means that investors will receive the remaining 87%. Conversely, if GAWA Capital excels in its impact efforts and attains a score of nine, it can claim up to 9%, while ensuring that investors still receive 81%.

On the other hand, compensation foregone because of impact underperformance can be directed towards achieving the fund's impact objectives through other means. For example, within carry mechanisms, the portion of impact carry that isn't achieved can be directed to an organization, such as an NGO, that focuses on the Fund's impact objectives. Interviewees did not discuss forgone compensation mechanisms for bonus structures, but a similar approach could be applied.

### **IMPACT PARTNERS: REDIRECTED TO AN EXTERNAL PARTY**

After reaching their investment hurdle rate, Impact Partners evaluates whether it has reached its impact hurdle of 60%. Should it not reach 60% of its impact targets across the portfolio it forfeits all of its carry to NGOs that will help indirectly reach these targets. Should it exceed its impact hurdle of 60%, the carry is pro-rated with any unearned carry donated to NGOs.

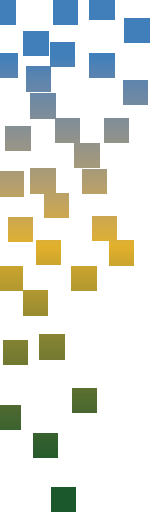
### **Documentation and administration**

This report highlights the many considerations that feed into an ILC structure and management which need to be clearly documented to create clarity, transparency and accountability among stakeholders. Most, but not all funds document ILC in the limited partnership agreement (LPA). Concerns about the flexibility to adjust ILC terms and the approval process required to amend the LPA can push ILC provisions into other documents like side letters, charters, and subscription agreements.

Many carry mechanisms have a gap between when managers earn carry from a financial perspective and when carry is unlocked by impact performance. Carry is earned when financial hurdles are met but not unlocked until the end of a fund's life, when final impact assessments can be made. Most funds hold the eligible impact-linked carry in escrow until distribution. Escrow and redistribution of unearned carry are additional ILC terms that should be included in the legal documentation, whether in the LPA or elsewhere.

### **Conclusion**

Whatever ILC mechanism is chosen, it is a way to further integrate impact in fund operations and incentives. First-generation ILC models will likely evolve. For example, funds may move from bonus to carry or choose to add performance evaluations of the portfolio company teams or some combination of all of the above. Stakeholder feedback about ILC outcomes and consequences can shape second-generation ILCs. Last, but not least, whatever ILC is implemented, sharing the approach and lessons learned with funds and the impact community will help facilitate other first adopters and the evolution of second-generation ILCs.



# YARDSTICK DECISIONS

Table 4: **YARDSTICK DECISIONS**

YARDSTICK DECISIONS		
Selecting metrics	Setting targets	Getting to the portfolio level (or not!)
Relevant impacts	Level of ambition	Top-down vs. bottom-up
Proxies	Time frame	Weighting results
Number of metrics	Level of flexibility	Opting out of portfolio-level aggregation

GPs and LPs consistently identified target and metric-setting as the most challenging part of ILC design. Several survey respondents, interviewees, and convening participants expressed how hard it is to craft an appropriate – meaning tailored, ambitious, and aligned – yardstick. In our survey, the fund managers that did not currently have ILC cited the complexity of ILC and the difficulty of standardizing IMM at a portfolio level as the biggest factors keeping them from linking compensation to impact. Metrics and portfolio-level standardization were consistently identified during the convening series as among the most pressing concerns for fund managers designing ILC.

In this section, we break down yardstick decisions into three focus areas: selecting metrics, setting targets, and getting to the portfolio level (or not!). Each of these decisions has three considerations that we explore.

As discussed in the [Methodology](#) section, the breadth of funds surveyed and interviewed for this project is large, with nearly every type of impact sector represented. As such, while we were not able to specify guidance to any type of fund, we believe the lessons in each of these sections are applicable across size, sector and geography.

YARDSTICK DECISIONS
<b>Selecting Metrics</b>
Relevant impacts
Proxies
Number of metrics

## Selecting Metrics

Metric selection is a core decision when designing (and revising) ILC structures, because compensation is based on an impact performance assessment that must ultimately be measured by a metric or metrics. Determining which metrics to use in performance assessment requires fund managers to identify relevant impacts and determine proxies for these impacts. The number of metrics linked to compensation, based on the number of impact objectives linked to compensation and what is needed to create proxies, is also a key decision.



### Relevant impacts and outcomes

All funds (and their investees) have impacts – positive, negative, intended and unintended – but not all impacts are equally important or significant. See [page 5](#) for the definition of impacts and outcomes and how the terms are framed in this report. The relevance of any given impact is determined by the context in which the fund operates, the fund’s goals and objectives, and the needs of end-stakeholders affected.

The importance of linking compensation to relevant impacts is often best described via an example of irrelevance. Consider a hypothetical investment by a private equity firm in a healthcare company in an underserved area. The healthcare chain has many impacts on its stakeholders, both positive and negative, including the communities it serves, the people who work for the company, and the environment. The private equity firm chooses to link its internal compensation structure to the amount of paper recycled at the company. While this is an impact that could be important to manage, it is not the impact most relevant to the company (or likely to its stakeholders). The importance of identifying relevant impact and outcomes cannot be overstated. In this example, it is possible for a fund manager to implement an ILC structure “successfully” with no real positive impact on the lives of people or the planet. See the [Further Research](#) section for areas of additional research around this topic.

### MATERIALITY

The topic of relevance is often framed in the context of materiality. A number of organizations are tackling materiality from the point of view of end-stakeholders affected, including Social Value International and the Impact Management Platform. It is also a core focus of Impact Frontier’s Impact Performance Reporting Norms. See the resources from these organizations for more information on this important topic.

### SUSTAINABILITY-LINKED LOAN/ BOND PRINCIPLES

**While the focus of this research has primarily been in alternative assets, specifically VC/PE funds, guidance designed for other impact products dealing in incentives is highly relevant. For example, the Sustainability-Linked Loan Principles were developed with the aim of creating consistency and credibility for Sustainability-Linked Loan (and Bond) products and include guidelines on the selection of relevant metrics (which are referred to as KPIs).**

*“KPIs must be:*

- *relevant, core and material to the borrower’s overall business, and of high strategic significance to the borrower’s current and/ or future operations;*
- *measurable or quantifiable on a consistent methodological basis; and*
- *able to be benchmarked (i.e. as much as possible using an external reference or definitions to facilitate the assessment of the sustainability performance target’s level of ambition).”*

### - Sustainability-Linked Loan Principles (February 2023)

Sustainability-Linked Loan Principles

The topic of Selecting Metrics is directly related to the role of governance in overseeing metrics used as the basis for ILC. See [page 38](#) for more details.



This research did not assess the relevance of the impacts chosen by funds, but it did explore the ways in which funds choose relevant impacts. Funds that participated in our research have approached the selection process in different ways, often relying on more than one approach. These approaches include but are not limited to using a third-party standard, seeking input directly from end-stakeholders (or indirectly through third parties such as 60dB, an impact measurement company), and aligning to evidence that connects chosen metrics with the Fund’s impact objectives.

**GAWA CAPITAL: CHOOSING IMPACTS BASED ON A THIRD-PARTY STANDARD**

GAWA Capital’s mission is to transform the lives of vulnerable communities. Its second fund, launched in 2014, the Global Financial Inclusion Fund (GFIF), linked carry to compensation with a composite score of 25 metrics reflecting the Smart Campaign Client Protection Principles (CPP) and aligned to GIIN IRIS+. At the time, the CPP was the first global client protection standard developed for low-income customers of financial service providers. As third-party standards in financial services have evolved, so too has GAWA Capital’s compensation structure.

**BROADSTREET IMPACT SERVICES: CHOOSING IMPACTS BY INVOLVING THOSE IMPACTED**

Broadstreet Impact Services supported a forestry fund in the design of its ILC structure. The fund has three goals when making investments in distressed rural communities: increased economic opportunity, increased community wealth, and increased community resilience. Although these goals are consistent across investments, the context, and therefore the metrics used to assess these objectives, varies across communities. To ensure the chosen

metrics are relevant to each context, the fund’s Impact Advisory Council sets metrics and targets for each community. The council consists of internal staff from the investee organizations, Broadstreet, and an expert in rural development whose role is to build local partnerships in the community for the fund and represent the community voice in several areas, including in metric selection.

**HAPPINESS CAPITAL: CHOOSING IMPACTS BY ALIGNING WITH EVIDENCE AND INVOLVING THOSE IMPACTED**

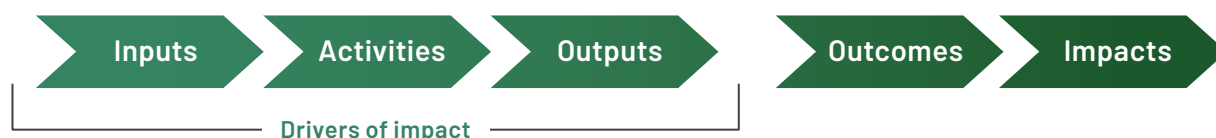
The mission of Hong Kong-based global VC Happiness Capital is to make the world a happier and healthier place. Its Happiness Return methodology, which is linked to the team’s internal bonus structure, considers both subjective and objective components of happiness. The ‘conditions’ of happiness are aligned to OECD Better Life indicators, and the ‘experiences’ are aligned to PERMA+<sup>7</sup> (a scientific model of happiness). Data is collected from end beneficiaries via 60dB; Happiness Capital also engaged an external consultancy to support the design of this framework.

**Proxies**

Impact, as defined by the Impact Management Project, is a change in a social or environmental outcome caused by an organization (see callout box on [page 5](#) for a more detailed definition). Impact pathways are often used to describe the link between organizations’ inputs, activities and outputs with their effects on people and the natural environment, notably outcomes and impact.

The graphic below from the [Impact Management Platform](#) presents a common model of an impact pathway.

Fig. 7: THE IMPACT PATHWAY



7 Seligman, Martin (2018): “PERMA and the building blocks of well-being,” The Journal of Positive Psychology, DOI: 10.1080/17439760.2018.1437466





The majority of ILC models we reviewed did not link to direct measures of impact. While many participants noted a desire to find ways to more directly link to impact measures, they expressed concerns about the difficulty and cost in collecting precise impact data. Respondents frequently reported that proxies – typically outputs, and occasionally outcomes – were employed as the basis for their ILC models.

Of the ILC models we looked at, funds used a variety of ways to define proxies for relevant impacts of focus. We also heard that organizations often used outside expertise, directly or indirectly, to identify proxies. Some methods of determining proxies are highlighted in the case studies below:

#### **ACUMEN: ESTABLISHING A CLEAR METHODOLOGY TO DETERMINE PROXIES**

Acumen is a global nonprofit aiming to change the way the world tackles poverty by investing in sustainable businesses, leaders, and ideas. Acumen has designed impact-linked incentives across several entities, for teams, investee companies, as well as Acumen as a fund. For example, Acumen's KawiSafi Fund linked impact to carry based on the number of lives impacted. It realized 100m lives impacted, well over the target. As another example, Acumen's Education Facility offers impact incentives to the company as well as Acumen as the investor. To guide internal processes for selecting impact metrics to link to compensation, Acumen established a methodology for determining proxies. This methodology sets out guidelines for credible and justifiable approaches for team members and companies to determine proxies, the types of source data that can be used, and ultimately the relevant metrics to be connected with the incentive. Importantly, these metrics must not only be practical but also require the team and company to be able to influence and claim attribution for them, to magnify the effectiveness of the incentive.

#### **WEAVE FINANCE: USING PROXIES AGREED BY INDUSTRY**

Weave Finance's Colorado Housing Accelerator Initiative (CHAI) invests in affordable housing projects, an impact area where proxies have been well established through government and industry practice. CHAI's impact-linked carry

structure is tied to the average median income (AMI) of the portfolio. CHAI noted that while AMI doesn't fully capture the impact it intends to have, it is a metric that is readily captured by investees and widely considered by affordable housing players in the US as a proxy for the level of need of the household being served.

#### **CHI IMPACT CAPITAL: SEEKING OUTSIDE EXPERTISE**

Developing proxies for pre-revenue companies that have a limited impact track record in the sector can be challenging. To record the most relevant impact metrics, Chi Impact Capital's (Chi) Head of Impact works with portfolio companies to create a baseline of robust KPIs that align with EU's Sustainable Finance Disclosure Regulation (SFDR). To ensure these KPIs are suitable proxies for impact, they are reviewed in collaboration with its impact validation committee, an independent body of two experts with sector-specific expertise for Chi's Burning Issues Impact Fund (BIIF).

A common approach to developing proxies is to use composite scores, which combine multiple metrics, often weighted, into a single score tied to impact. The two main types of composite scores we observed were those developed in-house, many based on the Impact Management Project's [five dimensions](#) of impact, and those based on a third-party tool or standard.

#### **ALIVE VENTURES: A COMPOSITE SCORE BASED ON IMP'S FIVE DIMENSIONS OF IMPACT**

ALIVE Ventures seeks to improve the lives of low-income communities across Latin America and has adapted a number of aspects of its ILC approach since establishing its first ILC structure in 2018. Its second fund, launched in 2023, linked carry compensation to a composite score based on IMP's five dimensions of impact and ALIVE's core impact objectives: quality-of-life improvements, gender inclusion, and reaching low-income communities. At exit of each portfolio company, ALIVE calculates a total impact score using data collected throughout the life of the investment. These scores feed into a composite, portfolio-level score that determines the award of carry, weighted by the amount invested.



### VOX CAPITAL: A COMPOSITE SCORE BASED ON A THIRD-PARTY TOOL

Vox Capital launched its impact-linked incentive program for its first fund in 2016. The methodology has evolved over time and is currently linked to the [B Impact Assessment \(BIA\)](#), a standard developed and governed by B Lab. The BIA is a composite score based on questions about a company’s practices and outputs across five categories: governance, workers, community, the environment, and customers. Vox portfolio companies are scored on the BIA annually, which feeds into a portfolio score calculated as an average of each company’s score weighted by net asset value (NAV). This portfolio-level score is linked to the fund’s carry compensation.

It was beyond the scope of this research to determine whether proxies were “practical and accurate” reflections of the overall impact objectives. This topic is discussed in more depth in the [Future Research](#) section.

### UNINTENDED CONSEQUENCES OF PROXY SELECTION

Conducting a detailed assessment on the quality of proxies used by fund managers goes beyond the scope of this research. However, we observed that incentives that don’t fully represent the impact targeted by the fund, often true of output level proxies, can have unintended consequences. For example, one fund we spoke to had a focus on improving the lives of individuals in low-income communities. The first iteration of its ILC linked compensation to the number of clients served. Although this is an important measure of scale, it did not account for measures of WHO was being served or HOW they benefited (or not).<sup>8</sup> The manager noted that as a result, the fund’s pipeline and investment selection process were skewed towards investments that could reach more people but may not have been serving them in meaningful or positive ways.

### Number of metrics

Because ILC structures are ultimately based on the achievement of targets as measured by certain metrics, how many metrics to link to compensation is a key decision and is directly related to the relevant impacts of focus and the practical proxies used. We observed that the majority of ILC models that link compensation to impact use between one and four metrics.

- Circulate Capital’s third fund links carry to one metric: tons of plastic pollution prevented, which is the core object of the Fund.
- Acumen’s KawaSafi Fund links carry to the lives impacted (including number of people impacted who live below the poverty line) plus CO<sub>2</sub> averted.
- Acumen’s Education Facility links performance-based finance to scores for breadth (lives impacted), inclusivity (poverty focus), and depth of impact (how much the students’ learning improved).
- DWM’s Displaced Communities Fund links carry to three portfolio targets: the number of refugees and internally displaced persons served by the fund, a proxy for livelihood improvement in host and source communities, and a metric for asset and income growth of the women being served.
- BII links bonus compensation to a single impact metric, which is a composite score called the portfolio [Total Impact Score](#).

### YARDSTICK DECISIONS

#### Setting targets

Level of ambition

Time frame

Level of flexibility

The metric(s) linked to compensation at the portfolio level is not necessarily the same as the metric(s) used to measure actual performance. In many instances, the metric linked to compensation was a composite score with many underlying performance measures feeding into it. Another common approach was to

<sup>8</sup> <https://impactfrontiers.org/norms/five-dimensions-of-impact/>



link compensation to the achievement of impact metrics and targets set at the individual investment level. See [Getting to the Portfolio Level \(or Not!\)](#) for more detail on decisions on standardization across the portfolio versus individualization at the investee level, as well as different approaches to tying impact to metrics at the portfolio level.

## Setting targets

A fundamental aspect of ILC is the setting of targets that determine the level of compensation. Setting targets with the appropriate level of ambition is essential to creating ILC structures that are aligned with the strategic goals of the fund. In our research, we identified several strategies funds use to assess the appropriateness of the target's level of ambition. We also saw different approaches for determining the time frames of targets, as well as different levels of flexibility in changing or adapting targets throughout the lifecycle of the fund. We explore each of these three considerations further in this section.

### Level of ambition

Setting an appropriate level of ambition for targets is essential for achieving impact objectives. Targets that are not ambitious or meaningful may not drive progress towards the fund's impact objectives, and targets that are too ambitious may be unrealistic and demotivating.

Many of our interviewees openly admitted to struggling with whether they had set ambitious targets, particularly when their investees have varying capacity to collect relevant baseline impact data in which managers need in order to develop impact targets. Determining an "appropriate level" of ambition can also be subjective. To address this subjectivity, we observed a number of instances in which funds used external inputs to set and/or confirm the level of ambition. For example, some fund managers use third parties to validate the level of ambition of goals set at the portfolio and/or individual investment level. Governance for assessing the level of ambition is a key consideration discussed further on page 38–39.

### DRAWDOWN FUND: USING THIRD-PARTY VERIFICATION TO ASSESS LEVEL OF AMBITION

The Drawdown Fund links carry to CO<sub>2</sub> emissions sequestered and greenhouse gas emissions reduced. The fund also works with each investee to define an "impact model," an analysis and

forecast based on various assumptions, the market context, company growth expectations, and so on. The impact model identifies the relevant metrics and targets that serve as proxies for impact achievement. The impact model, including its level of ambition, is then validated by a leading consultancy in the relevant space.

### MASAWA FUND: USING A GOVERNANCE BODY TO REVIEW AMBITION

Masawa Fund (Masawa), which invests in European startups catalyzing mental health and wellness, employs impact-linked carry. Masawa established an Impact Committee for broader impact oversight whose role is to review the targets set and provide input before proceeding.

### Timeframe

The target used as a basis for an ILC structure must be linked to a timeframe. While the majority of our respondents had traditional closed-end 10-year life funds, there was significant variation in the timeframes used to manage ILC targets. These differences are directly related to a fund's strategy, the impacts and metrics it uses, and the way in which it assesses performance at a portfolio level.

Examples of different approaches to setting timeframes for ILC targets are captured in the case studies below:

### CIRCULATE CAPITAL: FUND LEVEL TARGET SET FOR FUND LIFE

Circulate Capital ties carry to a target focused on plastic pollution prevented over the life of the fund. The ILC structure is part of the LPA, but the specific target is based on the fund's size at final close. The target is fixed for the life of the fund but is not defined until the final close.

### NUVEEN: INDIVIDUAL TARGETS FOR INVESTMENTS SET ON AN ANNUAL BASIS

Nuveen Private Equity Impact sets targets on an individual company basis annually and measures performance based on the percentage of that impact target achieved, according to its established target-setting protocol. This structure is specifically designed to reflect the stage at which Nuveen invests – growth equity – and to ensure flexibility for adapting to changing circumstances.



### Level of flexibility

Impact is dynamic. Respondents noted that the context in which a fund operates changes along with sector advances, research, and lessons learned, all of which influence a fund's strategy, impact management practices, and potentially the metrics and associated targets linked to compensation. Our research noted that several funds acknowledged these changing dynamics by building flexibility into their ILC structures.

Nuveen's individual targets, which are set annually, are an example of how funds incorporate flexibility into the design of their ILC structures as well as the ability to revise targets. Other examples of this flexibility are illustrated in the case studies below:

#### **MIROVA GIGATON FUND: EX-POST DESIGN OF ILC METHODOLOGY**

The Mirova Gigaton Fund is a fixed-return debt fund seeking to accelerate the clean energy transition in emerging countries, predominantly in Africa and Asia Pacific. The fund has several impact goals aligned to the SDGs, such as but not limited to offsetting CO<sub>2</sub> emissions and advancing gender equality. The terms of an impact performance bonus were agreed with LPs in the fund documents prior to launch, but the specific metrics and performance assessment methodology will be determined in due course and are subject to agreed governance processes. The annual bonus does not commence until year eight of the fund's 15-year life, enabling the fund manager to design a methodology ex-post based on the real portfolio composition, rather than a hypothetical one.

#### **NEW FORESTS: FLEXIBILITY IN SETTING TARGETS WITH INPUT FROM LPS**

During the formation of AFIP, NF, in collaboration with cornerstone LPs, established four portfolio-level targets for the desired level of impact achievement at year 10. Though AFIP is an evergreen vehicle, the compensation structure follows a typical closed-end fund timeframe. After deployment, each asset will provide baseline data for each of the four impact metrics. Depending on the assets in the fund, the targets may need to be adjusted up or down to ensure they are sufficiently challenging but still within reach during the impact period. Any adjustment will be agreed with fund LPs through the appropriate fund governance structure(s).

#### **MASAWA FUND: TWO SETS OF IMPACT TARGETS DEPENDENT ON COMPANY STAGE**

Masawa invests in early-stage companies that may change their product and strategy as they grow. As such, Masawa and the founders initially co-create provisional impact targets that help the companies get to product-market fit; if there's no product-market fit, there's no impact. Then, at Series A, Masawa co-creates the long-term impact target to which Masawa is held to account.



YARDSTICK DECISIONS
Getting to the Portfolio Level (or not!)
Top-down vs. bottom-up
Weighting results
Opting out of portfolio-level aggregation

### Getting to the portfolio level (or not!)

One of the most common challenges we heard from funds involved aggregating impact performance. The [Methodology Section](#) noted that the majority of funds not currently using ILC cited the difficulty in standardizing IMM at the portfolio level as the number-one reason keeping them from linking compensation to impact. This aligns with the common discourse about ILC, where it is seen as too difficult and/or reductive, to create a small number of metrics on which to determine compensation for funds with a broad social mandate.

Because many incentive structures are generally based on aggregate financial performance, aligning compensation to impact means finding ways to account for impact performance at a portfolio level. While rolling up financial performance into an aggregate IRR can be fairly straightforward, rolling up ‘impact’ to the portfolio level is not always straightforward, particularly without comparable and standardized impacts.

When aggregating impact at the portfolio level, we observed funds using either a top-down or a bottom-up approach. Within these approaches we also observed funds employing weighting methods. While the majority of ILC models we reviewed did roll up impact at the portfolio level, we did note that not all models have this approach. We review all three of these considerations in this section.

#### Top-down vs. bottom-up

As noted above, the majority of ILC structures are ultimately linked to an impact metric(s) and targets at the portfolio level. We observed two different approaches for how funds accounted for impact at this level.

- **Top-down:** In this approach, a metric(s) and target(s) are determined at the portfolio level. Metrics are collected consistently across all investments and aggregated to the portfolio level. For example, a fund links compensation to a CO<sub>2</sub> savings target and aggregates CO<sub>2</sub> savings across all investments to assess performance against that target. This practice was more common for funds with a more narrow impact mandate.
- **Bottom-up:** In this approach, one or more metric(s) and target(s) are determined at the individual investment level with different approaches used to aggregate performance to the portfolio level. The most common approach we saw was when funds select impacts and targets that were relevant to the specific investment and then anchor ILC at the portfolio level based on the binary or relative achievement of those individual targets. See the All-or-Nothing vs sliding scale section under [Mechanism](#) for more information on these two approaches.

As noted earlier, composite impact scores were a common portfolio-level metric used as the basis for a number of ILC structures we observed. Some of these scores use a top-down approach, where all investments are scored on the same metrics, while others use a bottom-up approach, where investments are scored on metrics tailored to each individual investment.

One of the key findings from our research was that the majority of funds in our ILC data set used a bottom-up approach to metrics and target-setting. This was particularly true for multi-sectoral funds focused on social impact.

#### KILARA CAPITAL: TOP-DOWN APPROACH USING CORE METRIC FOR EACH PORTFOLIO COMPANY

Kilara Capital is a A\$40 million fund based in Melbourne, Australia with a focus on climate change mitigation. It links ILC to the growth rate in tons of emissions mitigated. While other metrics based on the companies may also be recorded, Kilara uses the growth rates in emissions mitigated as the main proxy for ILC for the businesses it invests in. To do this, Kilara has set a 15% year-on-year target on the



growth rate in emissions mitigated. In practice this would mean that a portfolio company that has mitigated 100,000 tonnes in one year would be required to mitigate at least 115,000 tonnes in the following year. When this minimum threshold was set, it was kept in mind that the Paris Climate Agreements goal remains the same every year, but the annual change required gets larger every year that global emissions reductions fall short of targets. In light of this, requirements were set from the year the fund was opened (2021) when the number was 7.6% p.a. to meet Paris commitments, with a fixed 2x target at 15%. Kilara's target was set higher to account for changes in this target while remaining sufficiently ambitious, and to avoid rebasing the target each year. This approach, which requires using growth rates linked to scientific evidence, circumvents the size effects that would make setting absolute targets problematic should global targets change.

#### **EUROPEAN INVESTMENT FUND (EIF) METHODOLOGY: BOTTOM-UP APPROACH USING PORTFOLIO COMPANY METRICS AND IMPACT MULTIPLES**

The EIF methodology is based on the [gamma model](#) of impact metrics for fund investments and is a bottom-up approach. Funds using it define up to five metrics with each portfolio company and set pre-investment targets for each of those metrics. The fund manager then calculates and reports, on an annual basis, an impact multiple, which is defined as the ratio between the target and realized value. The percentage achievement of targets determines award of carry on a sliding scale. In general, at least 60% of the portfolio target value needs to be achieved before any carried interest is distributed to the management team.

#### **CHI IMPACT CAPITAL: BOTTOM-UP APPROACH DEFINING METRICS WITH PORTFOLIO COMPANIES**

Chi is the investment advisor of the BIIF, a Luxembourg-based impact venture fund targeting a US\$30 million fund AUM. The BIIF invests in for-profit European-based enterprises with a core-regenerative business mission to solve a burning social or environmental issue. These investments are made across several

impact themes, such as circular economy, green innovation and climate tech, and food systems transformation. At investment, Chi works with portfolio companies to define up to three impact indicators for each portfolio company that will serve as a proxy for the Impact Validation Committee to annually assess improvement in positive impact outcomes. Portfolio company scores are aggregated into a total point score that determines the amount of carry awarded.

In deciding whether to use a bottom-up or top-down approach, funds have latitude to reflect on what is fit for purpose within their own fund or funds. The approach may even change based on different funds' mandates within a specific fund manager.

#### **IMPACT PARTNERS: TAILORING THE APPROACH TO THE FUND MANDATE**

Impact Partners is a European impact private equity fund manager. It target investments in social enterprises who create solutions to support the most fragile communities, at all stages of life (youth, adults and seniors), in deprived areas (defined zones of need). Impact Partners has over €340 million under management across a seed-stage fund and growth-stage funds. The seed fund has a narrow focus on creating private sector jobs in defined locations with higher need. As such, all portfolio companies report on job creation and sales data (proxy for economic activity), and compensation is tied to these impact metrics at the portfolio level.

By contrast, the growth-stage funds have a core focus on reducing inequality, which can take many forms: challenges in accessing work opportunities, barriers to education, mobility, inclusion, or other goals that are difficult to capture in any one metric. As such, Impact Partners took a different approach for the growth funds, choosing instead to make an assessment for each investment in due diligence to define the relevant metric(s) that measure progress towards its goal of reducing inequality, based on the portfolio company's strategy and business model. Example metrics include the number of buildings made accessible to persons with disabilities and the number of unemployed people who have returned to work. These are measured on an individual basis and rolled up to produce a portfolio-level total score.



## Weighting results

Our research noted fund managers took different approaches to accounting for impact at the portfolio level. Weighting “impact performance” is one approach to assessing performance of investments of varying sizes and different stages of business growth.

Funds used different bases for weighting results. Some funds use an internal weighting system based on criteria specific to the fund, where other funds weigh impact data by the amount invested in the portfolio company or the fund’s ownership percentage in the portfolio company. In this later example, low-dollar investments or those that take a minority stake would receive less weight in the fund impact score than larger or majority position investments.

### **GAWA CAPITAL: WEIGHTING BASED ON INTERNAL CRITERIA**

GAWA Capital’s Huruma Fund focuses on improving access to finance and building climate resilience for smallholder farmers in rural areas of Latin America, the Caribbean, sub-Saharan Africa and Asia. The ILC methodology weights performance assessment depending on whether the investment is in a dedicated agricultural lender or a generalist SME financier who is being supported to develop agricultural capacity. This means that it adjusts its measurements depending on whether the investee is an agricultural lender (and therefore already has agricultural capacity) or if it is a general financial service provider and GAWA is using its technical assistance to help the investee improve their agricultural capacity.

### **VOX CAPITAL: WEIGHTING BASED ON NET ASSET VALUE**

Vox Capital’s portfolio-level score is calculated annually as the average of individual portfolio BIA scores, weighted by NAV. For example, in a hypothetical portfolio of three companies of equal value, with BIA scores of 60, 80 and 100, Vox would score 80 points on average (the hurdle score). If the same three companies instead represented 45%, 10%, and 45% of the portfolio, respectively, Vox would still achieve 80 points overall. The fund’s final score, which will be taken into account to unlock the ILC, is a simple average of the scores over the fund’s life.

## Opting out of portfolio-level aggregation

Our research showed that most funds tended to link compensation to portfolio impact level performance, likely a reflection of a PE/VC dominant sample, where carry is awarded based on portfolio performance. Despite this, there were a few examples of funds that based their ILC on impact performance at the individual investment level or the community level.

The case studies below illustrate compensation determined not by aggregate portfolio performance but on an investment-by-investment basis.

### **DRAWDOWN FUND: ENSURING IMPACT PERFORMANCE**

The Drawdown Fund’s total carried interest is determined via a traditional European Equity Waterfall, and once the fund is in carry, 50% is paid out based on financial performance. The other 50% of carried interest is tied to impact goals. The fund works with portfolio companies to set impact targets, and assesses impact performance for each company against those targets. If, on exit, the impact targets of a portfolio company are not met, the fund will deploy a proportionate share of the available carry philanthropically to meet those targets. This aligns with the fund’s waterfall structure, where the GP is paid deal by deal for impact targets.

### **BROADSTREET IMPACT SERVICES: PROPORTIONATE GROUPING OF ASSETS**

For a Broadstreet-advised forestry fund, impact performance is assessed at the community level, and compensation is also awarded proportionately at the community level. Community-level compensation means that the fund manager’s compensation will be determined by the impact performance and target achievement of each community the fund invests in, rather than by looking at an overall portfolio performance. To ensure this occurs, ILC is paid to the fund manager per community, after all investments in the community have been exited, subject to achieving the impact targets for that specific community. The amount of carry is proportionate according to the targets achieved; for example, if the fund invested in four communities and three achieved their impact targets, 75% of the available carry would be awarded.



## Conclusion

Yardstick considerations focus on the metrics and targets chosen to link to compensation and for many asset managers how impact is accounted for at the portfolio level. GPs and LPs consistently identified these considerations as the most challenging aspect of developing ILC structures. The framework above provides a number of design elements and examples that illustrate the different ways fund managers have approached each consideration. While Yardstick was identified as the area of leading challenge, in our research we saw clearly that there are a variety of options that accommodate different objectives and goals in a way that aligns with other aspects of ILC.





# GOVERNANCE DECISIONS

Table 5: GOVERNANCE DECISIONS

GOVERNANCE DECISIONS	
<b>Designing Structures</b>	<b>Determining Responsibilities</b>
Oversight bodies	Metrics and targets approval process
Level of LP involvement	Adjustments to metrics and targets
Use of outside expertise	Target, data and process verification

An effective compensation model requires robust governance. Effective governance is essential for establishing and upholding key decision-making processes aligned with the organization’s strategy and objectives.

Governance models for ILC structures should be a subset of the core governance model for a fund. Therefore, when thinking of good governance in the context of ILCs, funds should consider the tenets of good governance for impact investing. This includes models that ensure:

- **Accountability**, with a focus on fulfilling the fund’s mission and objectives.
- **Independence**, where there is impartiality and autonomy in decision-making, and conflicts of interest are avoided.
- **Alignment** between GPs, LPs and portfolio companies to measure impacts that are material. Materiality should be defined from the perspective of stakeholders.
- **Risk management** supported by clear processes that identify, assess and manage risks from a financial and impact perspective.
- **Transparency** through clear and open communication, disclosure of information, and decision-making processes.

To understand the decisions involved in creating comprehensive and coherent governance for ILC, we look at two focus areas for governance: Designing Structures and Determining Responsibilities. Within each of these decisions, we explore three considerations.

GOVERNANCE DECISIONS
<b>Designing Structures</b>
Oversight bodies
Level of LP involvement
Use of outside expertise

## Designing structures

In our interviews, funds repeatedly mentioned the need to design governance structures that were fit for purpose. Based on these responses, we’ve identified three categories to consider when designing governance structures. These are the oversight body, the level of LP involvement in impact-related governance, and the use of outside expertise.



## Oversight bodies

Deciding on the need for and the type of oversight body (or bodies) to oversee ILC is one of the first set of decisions that a fund manager must make. In our research, we saw examples of both separate impact advisory committees and LP advisory committees (LPACs) or other governing bodies with impact considerations integrated into their responsibilities.

### PRIME COALITION: SEPARATE COMMITTEE – MISSION ALIGNMENT COMMITTEE

Azolla Fund I is a US\$239 million fund seeking gigaton-scale climate impact. The Investment Manager is Azolla Management Company, an independent venture capital management company founded in 2021 by Prime Coalition (“Prime”). Prime is a US-based charity founded in 2014 to steer and influence capital toward scalable solutions to climate change.

Prime’s practices for compensation and oversight of investment managers are driven by its need to align incentives to its non-profit mission. Prime established a mission alignment committee (MAC) to ensure the fidelity of any investment program Prime established to its charitable mission, including Azolla.

The MAC has a minimum of three and a maximum of seven members, who are appointed by Prime’s board of directors. Prime employees or directors are ineligible to sit on the MAC, but representatives of Prime’s externally managed funds are eligible. Currently, the MAC has five external members.

Because Azolla is a blended fund, 50% of carried interest is subject to the achievement of internal mission lock criteria. For Prime Impact Fund, a fully charitable fund Prime established in 2018, management incentive payments are 100% gated by achievement of the mission lock criteria. The MAC votes to determine whether each portfolio company meets the mission lock criteria at the time of exit. MAC members who are representatives of the fund’s limited partners are recused from voting.

### CHI IMPACT CAPITAL: SEPARATE COMMITTEE – IMPACT VALIDATION COMMITTEE

Through the lifetime of each investment, Chi collects and measures the impact data from each portfolio company on a biannual basis. Because

its ILC mechanism relies heavily on this data (next to the achievement of the financial hurdle), the impact data is reviewed and validated annually by a separate fund governance body called the impact validation committee, which comprises two independent, external experts in the BIFF’s target impact areas.

### NUVEEN: INTEGRATED GOVERNANCE

A large, established fund manager, Nuveen’s Private Equity Impact strategy elected to integrate ILC oversight into its existing governance structures. The team was already focused on ensuring that it measures impact performance on valid indicators of performance, and sets ambitious and rigorous targets against those indicators. To achieve this, Nuveen developed a target-setting protocol, which it has used for several years to set annual targets. This year, the Nuveen Private Equity strategy has begun working with a third party to verify that the metrics are valid performance indicators, and that the targets are sufficient. Nuveen then includes target-setting in regular reporting to LPs.

*“What we are doing is basically setting a protocol for the allowable ways to set targets to ensure that they’re sufficiently ambitious and sufficiently rigorous.... Then we have an external verifier who will come in and say on an annual basis ‘Yes, Nuveen has selected the most valid indicator of performance for this company, that is measurable and reasonable for them to collect, and yes, Nuveen has set sufficiently rigorous targets in alignment with this protocol that you all have agreed on... for this calendar year.’”*

**– Pete Murphy, Head of ESG and Impact in Private Equity Impact Investing, Nuveen**



### Levels of LP involvement

Nearly all survey respondents with ILC reported that feedback from LPs about their compensation structure was somewhat to mostly positive; a few said feedback was neutral. A common theme was the signaling effect of ILC with LPs. Interviewees noted that it “strengthened the credentials of the fund”, “made fundraising easier” and reinforced the “belief that we can deliver on our return targets while serving the households we seek to benefit”.

Despite this positive market reception, in our research we found that the level of input funds receive varies considerably. In addition to traditional factors such as the size of the stake in the fund, LPs’ relevant sector experience and their familiarity with IMM principles and implementation determine their level of involvement. Development finance institutions (DFIs) and multinational investors seem more likely to request ILC and/or be comfortable engaging with funds on its design and governance.

One of the most active DFIs in the ILC space is the European Investment Fund (EIF). As the first LP to require fund managers to introduce ILC in specific parts of their portfolio, the EIF has played an outsized role in moving the industry towards more ILC.

The idea to add an ILC element to the EIF’s funding requirements came from Uli Grabenwarter, now Deputy Director of Equity Investments for the EIF. In 2012, Uli had just returned to the EIF from a sabbatical, during which he had undertaken an 18-month research project with IESE business school on family offices’ approaches to impact investing in private equity and venture capital. Upon his return, he was tasked with building the “first pan-European fund of funds for investing in social impact and social venture funds”. Based on his research, he developed the EIF’s methodology for ILC and began integrating it into this fund of funds.

### EIF: STANDARD MECHANISM, FLEXIBLE YARDSTICK, EXISTING GOVERNANCE

Several respondents and interviewees in our research received anchor funding from the EIF Social Impact Accelerator (SIA) or climate mandates, which require fund managers to introduce the EIF’s social impact performance methodology. The structure of the EIF mechanism is designed top-down by the LP and has limited scope to vary, but it allows fund managers complete freedom in yardstick decision-making (choosing metrics).

After the design, EIF oversight is integrated into existing governance structures, with a focus on monitoring the achievement of the fund’s theory of change. In an internal evaluation of the SIA conducted by the EIF Operations Evaluation Division in 2020, in conjunction with external consultants, nine of 12 fund managers interviewed “believed that the social impact-based carry mechanism had a moderate or large impact on the quality of the monitoring of social impact.”

*“The most important thing is to stress that this [impact linked compensation structure] is not something to quantify the achieved impact in absolute terms, for example it is not meant to reflect the CO<sub>2</sub> footprint of the portfolio manager.... The question that is asked is: has the theory of change, which has been the basis of decision to invest in a portfolio company, materialized?... It’s not a question of how much impact has been achieved in total...if you look at it across the full portfolio of the manager, then that gives you a perspective of how successful a fund manager is in selecting portfolio companies that are capable of implementing their impact agenda and delivering on their theory of change.”*

**- Uli Grabenwarter**



The timing of the design of ILC is important in guiding the level of LP involvement. GPs that designed ILC ex-ante, particularly prior to fundraising, noted that LPs had very little involvement in governance. The opposite was true for funds that were able to work together with an LP to design their ILC structure.

#### **NEW FORESTS: DESIGNING ILC WITH AN LP**

NF established AFIP with anchor investment from BII, Finnfund and Norfund. While setting up the ILC structure, BII, Finnfund and Norfund engaged in a positive, outcomes-focused discussion with NF on the design of the mechanism and the target setting. The design discussions were wide-ranging and covered a variety of topics. They aimed to strike a balance between being conservative and ambitious, and to balance the need to test and learn when setting a meaningful incentive. When it came to target-setting, this involved discussions on the level of carried interest linked to impact, ranging from 10% to 50%. The amount of carry tied to impact was set at 20% as a result of these discussions.

Regardless of their level of involvement in the design, LPs can play a significant role in the governance of a fund's ILC. Impact Partners' LPs involvement in target validation is a good example.

#### **IMPACT PARTNERS: LP VALIDATING TARGETS**

Impact Partners is a European impact private equity fund manager. It targets investments in social enterprises who create solutions to support the most fragile communities, at all stages of life (youth, adults and seniors), in deprived areas (defined zones of need). Impact Partners has €340 million+ under management across a seed stage fund and growth stage funds.

Impact Partners' fund managers are responsible for setting targets based on the impact and business plan's of the portfolio company. At the time of making a new investment, Impact Partners LP advisory committee will meet to validate the targets. These advisory committee meetings have strong attendance; "...that's something that they [LPs] really want to do. Because they see firsthand the impact of the company...the performance and the impact that we expect for each investment."

Many interviewees noted that they would like their LPs to play a more meaningful role in both ILC design and ongoing impact-related governance, particularly in challenging the fund's assumptions and pushing for more ambitious targets.

*"On the LP side, there is a strong opportunity to improve how the whole impact investing industry thinks about and implements ILC structures. If LPs can develop a deeper, more nuanced understanding of ILC, they can really help drive accountability across the industry, and not just accountability for deployers of capital and investees, but also accountability to end beneficiaries."*

**- Alan Pierce, Impact and Knowledge-sharing Manager, ALIVE Ventures**

Some funds described frustrations with the level of or type of input from LPs. One fund manager described ILC as making 'intuitive sense,' believing in the alignment of incentives, and incorporated an ILC structure after negotiation with an anchor LP. They expressed some frustration that despite having pushed for ILC, the LP was relatively hands-off when it came time to design the structure. The design process took time, the fund manager incurred costs; despite this, the fund manager does not regret incorporating ILC. The fund manager believed that where an LP has a strong interest in ILC, it should bear some of the costs involved, particularly when working with emerging or small-scale fund managers.

Despite this comment, there were few truly negative experiences. This is likely a reflection of the sample of funds that were interviewed, all of which had incorporated ILC. None of the funds we interviewed that aimed to incorporate ILC failed to do so.

From the LP perspective, some of our LP interviewees were interested in being more involved in the design and ongoing implementation of ILC as their portfolio of investments using ILC grows.



Our interviews and survey responses indicate this will be a welcome development for many GPs.

### Use of outside expertise

LPs have been traditionally viewed as the governance body for oversight for traditional funds, but given the important role governance mechanisms have in holding fund managers accountable to a fund’s dual impact and financial objectives, expertise related to the fund’s impact objectives may be needed. This can be filled by specialized staff within an LP or may involve independent specialists who can play an important role in establishing independence and preventing conflicts of interest. Additionally, funds can leverage the expertise of the stakeholders affected by their investments, i.e., the end consumers, employed workers and casual labour, and suppliers.

Funds can bring in outside expertise at any point in the design of the ILC structure or as part of ongoing governance. We found many examples of fund managers who brought on specialized firms, individual experts, and data from stakeholder engagements for their insight and additional accountability.

#### BROADSTREET IMPACT SERVICES: INDEPENDENT EXPERTS ON OVERSIGHT BODY

Broadstreet Impact Services, an impact fund services provider, works closely with partners to design, launch, and/or manage investment vehicles. Broadstreet was engaged to design and structure the ILC, including governance components, of an external place-based fund. The fund has three impact goals: to increase economic opportunity, increase community wealth, and increase community resilience, but the context will vary in each community the fund is investing in. Broadstreet has developed and will sit on the impact advisory council (IAC), alongside an expert in the specific impact area. The IAC’s role in ILC is to identify appropriate impact metrics and set targets for each community.

#### NEW FORESTS: LEVERAGING PREVIOUS FUNDS’ EXPERTISE

NF drew insights from its funds in Asia and other funds in the market for the design of its ILC in AFIP. They also had the support of a sustainability team in Sydney and collaborated

LPs with experience in African forestry investments. The combination of expertise and shared knowledge helped shape the structure and target-setting process.

Many of the interview respondents reported that the use of outside expertise was essential in the design and ongoing governance of their ILC structure. This was the case for both small funds and larger funds. Small funds said they had to spend wisely when investing in outside expertise, but they reported that the additional input and oversight complemented their otherwise capacity constrained teams. One fund was able to use expertise in the form of an Impact validation committee made of voluntary experts who helped inform its ILC governance.

GOVERNANCE DECISIONS
<b>Assigning responsibilities</b>
Metrics and targets approval process
Adjustments to metrics and targets
Target, data and process verification

### Assigning responsibilities

The governance responsibilities in the design and implementation of ILC can include approving metrics and targets, confirming adjustments to these metrics and targets, and can include verifying ILC data. Another important responsibility looking at the broader implications of the fund’s ILC structure, including potentially perverse incentives created by ILC structures. See the [Perverse Incentives section](#) for more details.

Fund managers typically agree a metric and/or target-setting methodology with investors at the time when the fund is established. Funds then use a combination of the governance responsibilities described below for ongoing oversight. The level of oversight varies by how much engagement is required.

### Metrics and targets approval process

A key element of governance structures supporting ILCs is approval of the impact metrics and targets to be used for ILC. These approval processes ensure targets are ambitious but also flexible and adaptable. Governance mechanisms should



balance *oversight* with the appropriate level of *flexibility*, all while holding the manager *accountable* to its impact objectives.

Several funds we interviewed described approval of the chosen metrics and/or targets as a key role in impact governance by a specified oversight committee.

*“When we wrote the [ILC] policy we laid out very clearly which metrics could be changed and who had approval for them. Some of them were at the GP level, and some of them had to go to the [LPAC]...[and] the conditions for those kinds of changes. If you want to change a metric or a given target, then what are the circumstances where you can do it? And also, for instance, what happens if there’s a major liquidity event? Those kinds of things we have documented in the policy.”*

**– Kaylene Alvarez, Founder and CEO, Athena Global, in reference to an advised fund**

#### **DW MARKETS: INVESTMENT COMMITTEE PLAYING A KEY ROLE IN APPROVING TARGETS**

DWM’ Displaced Communities Fund has the primary goal of improving financial resilience and livelihood opportunities for displaced and vulnerable persons, through a gender lens. The fund has three portfolio level goals: the number of refugees and internally displaced persons (IDPs) served by the fund, livelihood improvement in host and source communities, and asset and income growth of women who are served directly by the portfolio company. The fund team works with portfolio companies to set targets related to these goals. Prospective investments are evaluated by the investment committee, which is composed of internal members and an independent director. One of the IC’s roles, in evaluating or in approving any potential investment opportunity, is to approve the impact targets associated with that investment.

Where there is no formal process for approving metrics and targets, funds typically agree a metric and/or target-setting methodology with investors at the outset of the fund. In such a case, oversight typically involves reporting on (rather than approval of) the metrics and targets. This was seen both in regular reporting and as an agenda item of the LPAC. An LP could, at its discretion, investigate the selected metrics or targets in more depth.

#### **Adjustments to metrics and targets**

In our research, participants consistently emphasized the fluid and evolving nature of the investment landscape, particularly among early-stage investors. As a result, goals and targets may require adjustments throughout the investment cycle to remain responsive to dynamic conditions. See the [Flexibility section](#) on page 29 under Yardstick for more context and examples of how funds approach adjustments to metrics and targets.

In some cases, the LPA may give the fund manager the authority to make changes at their discretion, as long as they adhere to the LPA’s overall terms. When considering this model, fund managers should also consider earning broad stakeholder buy-in to ensure the adjusted metrics and/or targets still support the targeted outcomes when changes are made. The frequency of reviews and means of securing stakeholder input should also be considered.

Other models may stipulate that an advisory committee approves changes to metrics or targets. In some instances, these advisory committees may consist of or receive recommendations from specialist consultants; they may also have some form of LP representation.

#### **SHIP2B VENTURES: FUND MANAGER FLEXIBILITY**

Ship2B Ventures allows its own team to change the metrics and targets in its ILC structure, subject to approval by the Advisory Board, which is made up of Ship2B Venture’s main LPs. Proposed changes are evaluated in biannual team meetings and implemented annually; obtaining stakeholder buy-in before implementation is encouraged. The LPA commits Ship2B Ventures to a set of indicators from its theory of change, but it offers some flexibility in allowing adjustment of targets when needed, and providing a 6 to 12-month period to set targets.



### Target, data and process verification

Third-party verification can play an important role in overall governance structures and in creating transparency, accountability and independence. Verification can occur at multiple points within ILC oversight, including at both the “front end” and “back end”, as well as through ongoing verification that may include process auditing. A fund’s resources will typically influence the timing, process, and extent of verification.

#### FRONT-END VERIFICATION

Front-end verifications provide outside assurance that impact goals and targets are relevant and ambitious as well as verifying baselines.

#### BACK-END VERIFICATION

Back-end verification certifies the underlying impact performance data and information that will ultimately determine compensation. This can be done on exit or annually. Back-end verification can be used to assess whether data is correct and/or agreed targets have been sufficiently met.

#### DW MARKETS: FRONT-END AND BACK-END VERIFICATION

DWM asked an external impact advisor to verify the baselines of its targets and metrics. Where it sets targets internally, DWM selects components of the process to be validated externally. It also secures external verification to determine it has sufficiently met impact hurdles to unlock compensation.

#### ONGOING VERIFICATION

Fund may also choose to verify performance data related ILC structures on an ongoing basis, rather than just at the time of exit and/or at the time in which compensation is determined.

#### HAPPINESS CAPITAL: ONGOING THIRD-PARTY OVERSIGHT

Happiness Capital is a private corporate venture capital fund that has tied its own impact-linked bonus to its “Happiness Return” framework, a comprehensive assessment conducted by SVT Group, a social and environmental impact consultancy. Happiness Return is defined as “the impact the investment has on the objective and subjective components of people’s happiness”, and the framework is a composite score that considers both the conditions and experiences of happiness.

Happiness Capital has engaged independent third parties extensively in co-creating the framework, ongoing assessment and oversight. The framework has five steps, the last of which is to consider how each stakeholder responds subjectively to the venture impacts on the conditions and experiences of happiness, which will be validated through interviews and surveys conducted independently by SVT Group and 60dB. The interviews and surveys will provide business insights to investees and comparable data that Happiness Capital will use to validate the assessments. This ongoing verification process will help ensure the portfolio is generating the intended impact as measured by Happiness Return.

This use of verification showcases how governance activities help inform how impact is achieved.

### Conclusion

In this section, we’ve explored considerations for governance structures. In many ways, the design decisions in this category are the most crucial for the success of the ILC structure but often the least explored. From our surveys and interviews, we’ve noted how choosing the appropriate oversight body or determining the extent of LP input or external expertise can have significant ramifications over the years. Our research has highlighted that the governance responsibilities, including approving impact metrics and targets and adjusting them as needed, are a critical piece of ILC design. Finally, sufficient verification is vital. For instance, using only back-end verification at exit, without front-end verification or an evaluative criterion, could inadvertently omit assessing whether the targets or methodology are sufficient. Similarly, front-end verification used without back-end verification creates the risk that low-quality data is being used throughout the measurement period. Our research has suggested that this diverse governance approach not only aligns ILC with impact goals but also ensures the process is transparent, independent, and accountable, but more will be learned over time with evolving structures and future research.



# PERVERSE INCENTIVES

Perverse incentives in the context of ILC refer to situations where the design of compensation incentives unintentionally encourages the fund manager or LP to act in ways that run counter to the broader goals or values of the fund. These incentives can lead to behavior that is detrimental to the overall impact (and/or financial) objectives of the fund. Both GPs and LPs expressed some concerns about potential perverse incentives created by ILC.

The potential perverse incentives highlighted below depend very much on how the specific ILC is structured.

- **Unintended negative consequences:** When ILC structures are overly simplistic or narrowly defined, fund managers may take actions that have unintended negative consequences. See [page 26](#) for a tangible example of this that arose from our research. They may also fail to consider and mitigate impact risk if efforts to do so limit their ability to achieve the impact targets for which they receive financial rewards.
- **Lack of continual motivation:** Fund managers may be disincentivized to focus on continual improvements in impact once the achievement of the overall impact target is hit.
- **Misaligned incentives:** When carry that is forfeited because of impact underperformance goes back to LPs, LPs incentives regarding the GPs impact performance can become misaligned.
- **Cherry-picking investments:** ILC structures can encourage fund managers to prioritize investments that have easily attainable and/or measurable impact goals. This may lead to overlooking opportunities with greater potential for positive change.
- **Financial goal displacement:** ILC can be structured to prioritize achieving impact performance over the fund's overall financial performance. They may focus on activities that maximize impact performance but lead to suboptimal financial results.

In order for funds to achieve their impact objectives, managing and mitigating these potentially perverse incentives should be an integral part of an ILC structure. Many of the considerations highlighted within the Mechanism, Yardstick, and Governance sections can serve as the basis of funds' ability to identify – and therefore manage and mitigate – potential perverse incentives.

Our research indicated that many funds did not have formal measures in place to identify and mitigate these potential perverse incentives. We believe this is an important topic worthy of further research, especially as it pertains to governance responsibilities.



# FUND CONSIDERATIONS

While this report provides an overview of impact linked compensation using the mechanism, yardstick and governance framework, there are several factors and considerations that overlay all three. In this section, we discuss some of these considerations - highlighting why they are important and what aspects of ILC considerations they will likely influence. These considerations highlight issues such as the size of a fund, its overarching impact objectives, the relationship between proxies and financial returns, the track record of the fund, and how aligned LPs are to the fund's mission. These form just a subset of recurring issues that were noted, but are likely to vary based on the circumstances of your own ILC structure.




## Type of fund

### Why is this important?

The practice of tying impact to compensation can be used for any asset type and fund vehicle. The majority of funds surveyed for this research were in private equity, including venture capital, but we also had respondents from private debt and real asset funds, as well as funds with non-profit status. We also had several LPs that use ILC in their own company structure.

The structure of the fund, and the type of investments it makes, determine the fund manager's ability to influence investments, the return expectations, and how long assets are held. The type of fund also influences the type of investees (e.g., early vs late-stage, big vs small). All these factors have a significant influence on many ILC considerations.

Table 6: **DESIGN CONSIDERATIONS FOR DIFFERENT TYPES OF FUNDS**

CATEGORY	EXAMPLES
 <p><b>MECHANISM</b></p>	<ul style="list-style-type: none"> <li>• Evergreen funds are open-ended funds and therefore need to define breakpoints at which to measure and assess impact and when and how to compensate.</li> <li>• Blended-finance funds tend to have different target outcomes or return expectations for different LPs, and thus may not apply ILC uniformly to every portion of the fund. As a result, they should have clearly defined mechanisms that lay out compensation structures.</li> </ul>
 <p><b>YARDSTICK</b></p>	<ul style="list-style-type: none"> <li>• A buy-out fund can have significant control over portfolio companies and therefore tie compensation to impacts they influence directly.</li> <li>• VC funds are generally expected to have ~80% of their investments fail. VCs therefore should embed this consideration into compensation models, particularly where they are linked to targets at the investment level. For example, it might not make sense to hold fund managers accountable to impact targets for <u>all</u> investments, given that so many will fail.</li> </ul>
 <p><b>GOVERNANCE</b></p>	<ul style="list-style-type: none"> <li>• Blended-finance funds aim to use strategic public or philanthropic investment, to draw private investors to development-oriented projects or investments. Many of the stakeholders involved tend to have different target outcomes or return expectations, and funds will therefore need governance models that incorporate the inputs and oversight functions of these stakeholders.</li> <li>• VC funds invest in early-stage companies that have evolving business models and therefore evolving impact objectives. These funds need to be able to adjust metrics and targets to account for changes in the target market, business model, and products/services of investees.</li> </ul>






## Size of fund and supporting vehicles

### Why is this important?

In addition to a fund's type, its size is directly related to the resources that can be used to identify, measure and manage impact. Of the funds we surveyed, at least 84% of the respondents paid for ILC-related costs in part with management fees. Therefore the larger the fund, the more resources are available. These fees can be used to cover compensation for impact experts, data collection and sharing results back with stakeholders, impact management systems, and verification services, among others.

Table 7: **DESIGN CONSIDERATIONS FOR SIZE OF FUND**

CATEGORY	EXAMPLES
 <b>MECHANISM</b>	Interviewees expressed concerns about limited capital pools for bonuses in smaller funds, a limitation not expressed by larger funds.
 <b>YARDSTICK</b>	Because of the cost, the ability to collect data using third parties will depend on available resources and therefore may be limited for smaller funds.
 <b>GOVERNANCE</b>	Access to independent specialists and third-party auditors that support a fund's governance structure will depend on available resources. Smaller funds may have to rely on partnerships and/or volunteers to access outside expertise.

## The fund's impact objectives (broad vs narrow)

### Why is this important?

A fund's impact objectives depend on its investment strategy and areas of focus. This generally means that funds with narrower strategies (e.g., investments in micro-finance institutions) have much narrower impact objectives than generalist funds, which have multiple, and typically broader, impact objectives. The breadth of a fund's impact objectives influences many ILC considerations, including how the fund uses outside expertise and whether it approaches metrics from a top-down or bottom-up perspective.

Table 8: **DESIGN CONSIDERATIONS FOR TYPE OF IMPACT OBJECTIVES**

CATEGORY	EXAMPLES
 <b>YARDSTICK</b>	Narrow impact objectives and corresponding investment strategies may allow portfolio level goals to be set from a top-down perspective, whereas broad impact objectives and investment strategies may call for setting specific impact objectives at the investee level, to be rolled up to the portfolio level.
 <b>GOVERNANCE</b>	Funds with narrow impact objectives may be able to identify individuals with targeted expertise to be more actively involved in governance, while funds with broader impact objectives might need access to a wider range of expertise to cover the breadth of impact objectives.



## Relationship between impact proxies and financial returns

### Why is this important?

The scope and focus of this research prevent us from reporting on findings related to the relationship between impact and financial returns. However, our research has found that the relationship between impact proxies used for ILC and financial performance affects several ILC considerations. Limited resources and data require many organizations to use output metrics as proxies for impact. These proxies often have an assumed relationship to financial performance that can be positive, negative, or unclear.




The majority of ILC structures we examined assumed that impact and financial performance move in lockstep. An example is the number of customers served by an off-grid energy organization: the more people served, the larger the scale of both financial and impact performance. This is, of course, an oversimplification of the relationship but an example of the perceived positive correlation between impact and financial performance.

*“Our investment strategy is very focused around revenue alignments to impact objectives. So when we screen companies, we’re looking for companies that generate in excess of 95% of their revenue from products or services that generate [the] core social or environmental outcomes we’re seeking.... So basically, the company does well financially by selling more products, it generates more impact. Because of that, we don’t really view much of a tension between impact performance and financial performance.”*

**- Pete Murphy, Head of ESG and Impact in Private Equity Impact Investing, Nuveen**

Funds can use proxies where there is a negative, unclear, or non-linear relationship between impact proxies and financial return. Although we did not look in detail at all of the metrics used at the company level for those funds that used a bottom-up approach, we generally did not observe negative relationships in our GP data set; LPs, however, did raise concerns.

**Table 9: DESIGN CONSIDERATIONS FOR DIFFERENT RELATIONSHIPS BETWEEN IMPACT AND FINANCIAL PERFORMANCE**

CATEGORY	EXAMPLES
 <b>MECHANISM</b>	Where there is a perceived negative correlation between impact and financial returns, the mechanisms a fund chooses can consider meeting financial thresholds first.
 <b>YARDSTICK</b>	Where there is a perceived positive correlation between impact and financial returns, a number of LP interviewees expressed interest in linking more than one impact metric to compensation to account for the multiple dimensions and/or types of impact a fund could have.
 <b>GOVERNANCE</b>	Where there is a perceived positive correlation between impact and financial returns, interviewees noted the importance of governance mechanisms in validating impact proxies.



## Track record

### Why is this important?

Previous funds' experience and impact track record can inform their approaches to ILC. Experienced funds will be able to draw from existing data collection systems, impact assessment methodologies, and their own lessons learned when setting up ILC models. Those without relevant experience should plan for piloting, testing and evolution of their ILC models.

*“We linked bonus to our impact score in 2023 but had confidence in our ability to measure impact and create an ambitious goal because of our four-year track record in using our impact score not linked to compensation.”*

**– Caitlin Rosser, Director Impact Management  
Calvert Impact Capital**

Table 10: **DESIGN CONSIDERATIONS FOR FUND TRACK RECORD**

CATEGORY	EXAMPLES
 <b>MECHANISM</b>	A fund manager's experience and confidence in achieving its impact targets can inform its selection of mechanisms and quantum of ILC.
 <b>YARDSTICK</b>	Fund managers without a track record of funds with similar strategy and/or impact objectives may wish to design ILC structures that employ flexibility in metric and target setting while they establish a track record.
 <b>GOVERNANCE</b>	Fund managers without a relevant impact track record may benefit from governance mechanisms that play a strong oversight role in metric selection and target-setting to ensure impacts are relevant and targets are appropriate but ambitious.

## LP alignment on impact

### Why is this important?

Several of our interviewees raised a lack of consistency in LPs' approach to impact during their design of their ILC mechanism. As we have discussed in the levels of LPs involvement section, LPs' ambivalence to or skepticism of ILC is an obvious obstacle to structuring ILC, as are varying views on the importance of the funds' impact thesis. And conversely, when LPs agree on impact, it can be much easier to agree on the concept of ILC as well as the supporting governance, yardstick and mechanism details.

Notably, only 20% of our survey respondents without ILC cited a lack of LP interest as a deterrent to pursuing ILC. LP alignment may also evolve over time. LPs that were historically negative or ambivalent about ILC may become more positive and/or involved over time as they gain experience with ILC structures.

Table 11: **DESIGN CONSIDERATIONS FOR LPS ALIGNMENT**

CATEGORY	EXAMPLES
 <b>MECHANISM</b>	Funds with LP alignment on impact may be able to use it in negotiations on financial hurdles.
 <b>YARDSTICK</b>	For some LPs, ILC is a nice-to-have and not a requirement. A lack of agreement by LPs on the purpose of ILC could affect the GP's choice of metrics and the ambition of goals.
 <b>GOVERNANCE</b>	Interviewees discussed varying enthusiasm for ILC among their LPs, which affected their willingness to engage the GP on ILC structure. GPs seeking high LP involvement in ILC governance will need to ensure LPs agree on ILC goals.



# FUTURE RESEARCH

ILC touches on many aspects of a fund's operations, and as such there are a range of additional research considerations across accounting and tax, employee motivation, impact performance evaluation, governance and more that are relevant to this topic. As the field evolves, there are many possible future research directions, some of which we highlight in this section.

## Utility and best-practice research

The intent of this research was to study the GPs who have implemented ILC and to set out a range of practical considerations for fund managers who consider ILC in future. As such, this research does not contemplate methods of linking financial and impact performance that have not been seen in practice, nor does it make any attempt to classify manager approaches into best practices or make a determination on the usefulness of ILC. Such best practices are obvious areas for future study. The next five to seven years will see a rich dataset emerge, as the many fund managers in the sample who implemented ILC in the last two years commence cash distributions.

## Incentives research

Aligning incentives is a key motivation for fund managers who seek ILC. While this research touched on examples of the [perverse incentives](#) of ILC, further research into incentives, their design and governance would add depth to the discussion and could take many directions. For example, incentives research could investigate the effect of ILC (an extrinsic incentive) on the employee's intrinsic motivations, compared with traditional compensation approaches. Research could also explore impacts linked to compensation, which typically focus on positive impact, within the broader context of governance oversight of all impacts (both positive and negative). Another avenue to explore is the flow-through effect of ILC: where a fund has an ILC mechanism, how does it change contracting with and incentives for the portfolio companies? Some funds use ILC in tandem with impact-linked finance; examining this interplay, and the alignment of incentives across multiple levels is another angle.

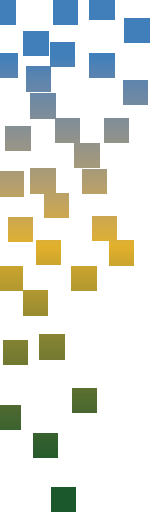
## IMM research

ILC adds several potential research areas aligned with broader examinations in the fields of program evaluation and sustainable accounting. Some of the concerns in the industry stem from broader problems with measurability, as highlighted in 'From Fiduciary Duty to Impact Fidelity' by Thirion et al. (2022). Another strand pertains to perverse incentives and unintended consequences of ILC. These consequences are not necessarily negative; for example, as motivations and incentives for robust IMM may vary among investor teams, further research could explore how ILC affects the perceived value of measurement compared with other priorities. Another potential avenue is the effect of ILC on strengthening the link between the intended impact goals and what is being measured. Interviewees and convening participants also described a desire to understand how to best link compensation to the achievement of outcomes.

One of the most commonly identified challenges was the difficulty of standardizing impact measurement at the portfolio level. Initial consultation from Impact Frontier's recently released draft [Impact Performance Reporting Norms](#) suggests that no standardized reporting template will be suitable for a diverse set of investors, but there is considerable agreement on the nature of information that should be provided and expected by recipients, including how to approach portfolio-level reporting. With the version 1.0 of the Reporting Norms expected to be released for testing in 2024, future research could explore how ILC helps, improves, or hinders reporting efforts.

## LP voice

As part of this research, we interviewed a small sample of LPs, including development finance institutions, family offices, foundations and other institutional investors. There is much more to explore in the LP perspective. For one, a greater understanding of the LP perspective would benefit fund managers, as we have discussed in this paper. Additionally, we know from our research that LPs



themselves are interested in implementing ILC. While we believe many of the decisions, focus areas and considerations that we've identified in this report will be useful to LPs, there could be another piece (or pieces) of work done on implementing ILC in family offices, foundations, and development finance institutions.

### Evolution of ILC

As ILC continues to evolve, an analysis of the trends would yield interesting insight into what works and what must adapt. Other interesting areas include the returns on investment (how ILC funds compare on returns for similarly situated funds) and moving beyond carry to ILC for the whole team.

**An academic research team, including Anne Tucker from Georgia State University's College of Law, a contributor to this report, is seeking to benchmark ILC and the effect on governance and measurement provisions in fund contracts. As the team's work previously demonstrated, impact agreements have stronger governance rights compared to non-impact agreements, and impact attention at the fund level results in stronger impact terms in portfolio company agreements. Their continued research on impact contract terms extends this work to ILC. Benchmarking ILC fund contracts against other impact contracts can provide evidence that ILC forces attention to yardstick and governance in the structure of the fund. Visit [impactK.ai](https://www.impactk.ai) to learn more.**



# CONCLUSION

This report on impact linked compensation (ILC) has sought to provide a comprehensive exploration of the diverse array of ILC structures found in practice. Fund managers who implement ILC are united by a desire to align incentives, foster accountability, and prevent misalignments such as impact-washing that have sometimes plagued the interests of various stakeholders in the investment arena. This report showcases the adaptability of ILC, emphasizing that incentivising impact is not a one-size-fits-all approach. Rather, ILC is a customizable toolkit that funds can tailor to suit their unique missions and objectives. Yet, given the central role of impact measurement and management (IMM), ILC is confronted with many of the inherent challenges and concerns of the broader measurement field.

Based on the work of Reward Value, we have proposed a framework for assessing ILC through its component parts: a yardstick to measure by, mechanism to link pay to performance, and governance to ensure the mechanism is meeting the intentions. ILC mechanisms take the form of bonus, carry or annual reviews, and depend on the fund size, structure, asset types, and more. In deciding a mechanism, fund managers choose between penalties or rewards, all-or-nothing or sliding scales, and what percentage of compensation to link to impact. In Yardstick, we've established the vital role of selecting relevant metrics and proxies, which are accompanied by target-setting practices, often developed at the investee level, and aggregated up to the portfolio level through weighting. Critical to all of this are governance structures that facilitate alignment and must achieve the right balance between oversight and flexibility.

The potential perverse incentives highlighted in this report serve as a reminder that ILC should not inadvertently overshadow other valuable impact activities or create counterproductive incentives. As such, ILC should be a subset of how a fund approaches impact, be approached with a testing and learning mindset, and involve affected stakeholders in design and decision-making.

With many fund managers in the sample having implemented ILC in the last two years, this report should be considered first-generation data and serve as a guide for funds contemplating its adoption. ILC is a customizable toolkit, and its effectiveness depends on how it is tailored to align with a fund's unique mission. But ILC should not be contemplated in isolation; its success or failure will be determined by the investment community and its commitment to transparency, collaboration, and sharing data. Future research such as on best practices, incentives, LP perspectives, and trends over time will continue to shape the direction of ILC. The report concludes with the hope that the work of these fund managers to align incentives will result in more capital being directed to the achievement of more and better positive impacts.



# APPENDIX - INTERVIEWEES

- Acumen
- Afrishela Investment Fund
- ALIVE Ventures
- Apollo Global Management
- Athena Global
- Big Society Capital
- British International Investment
- Blink CV
- Blume Equity
- Broadstreet Impact Services
- Builders Vision
- Calvert Impact
- Chi Impact Capital
- Circulate Capital
- Collective Action
- Drawdown Fund
- Developing World Markets
- European Investment Fund
- Fama Investimentos
- Gaia Fund Managers
- GAWA Capital
- Happiness Capital
- Impact Partners
- Kilara Capital
- Massawa Fund
- Mastercard Foundation Africa Growth Fund
- Maycomb Capital
- New Forests
- Nuveen
- PFC Invest
- Prime Coalition
- SABI Fund
- Ship2B Ventures
- Social Finance
- Sweef Capital
- Vox Capital
- Weave Finance
- Wilstar