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Social Impact Fund Management Routine

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1. Social Impact Fund

1.1. General considerations

The international project Social Impact Vouchers is based on two main pillars - the Social Impact Fund establishment and the Voucher System launch. The voucher system shall be financed by means of the social impact fund. The main aim of the social impact fund is to serve as a tool for pooling capital required to support activities that would be financed through a targeted voucher system.

The aim of this document is to describe Social Impact Fund Management Routine implemented to ensure securing daily operations in accounting, payment procedures, liquidity management, reportings, data collection. This routine is implemented subset of D.T2.1.5 Fund management protocol describing only applicable and implemented procedures that have been found useful through the pilot phase of the funds developed through the SIV project.

Routine has been implemented by the following partners and correspondent funds:

- Transnational fund run by PP1, PP2, PP3 and PP5 covering the following countries: Austria, Croatia, Germany and Slovenia
- National fund in Hungary run by PP4
- National fund in Czechia run by PP6
- National fund in Poland run by PP7 & PP8

All funds are unregulated, donation-based funds depending on the continuous fundraising to maintain their operations and with framework that ensures efficient utilisation of funds for the purpose of providing employment opportunities to disadvantaged social groups.

Funds will test other refunding mechanisms through their further development such as Social Impact Bonds or by transferring social benefits and value of employment to the employees seeking for new workers.

1.2. Elaboration of steps needed to setup the fund

1.2.1. Design of the fund

In order to successfully raise capital from potential investors, the fund management team must design a fund strategy and implementation plan. A well-designed fund strategy is, perhaps, not itself sufficient to attract potential investors, but no amount of marketing skill can help a poorly designed fund secure investment capital

An effective fund design comprises three key elements:

1. an investment and impact thesis;
2. fund foundation and structure;
3. coherent economics showing how fund objectives will be achieved

Though often initially tackled sequentially, beginning with the crafting of a compelling thesis and ending by ensuring sound fund economics, these elements are highly interdependent and require iteration. As a fund manager develops a more sophisticated understanding of potential investor interest, each element should be revisited and revised to create a coherent overall approach. For example, a fund's initial thesis and size may require revision once the team develops a detailed operating budget.

Particular attention of social impact fund in our case should be given to the decision if the fund is expecting to be delivering financial returns or will only be focused to deliver reports about measurable impact to the investors in the fund.

1.2.1.1. Building a fund management team

Structure

Only a very qualified team can effectively implement a fund's strategy and produce both financial returns and impact for investors. A typical fund management team includes three core roles: senior deal team leader, associate, and analyst. These roles can be expanded or collapsed as needed; for example, a fund may have multiple analysts or associates depending on its size and need. While advisors and experts are usually not considered part of the core fund management team, except for larger funds, they are regularly involved for specific deals, depending on their areas of expertise. The responsibilities of the fund manager include maintaining a roster of experts to consult when needed.

Impact Measurement and Management (IMM)

Impact fund managers also need to consider who will be responsible for measuring and managing the social and environmental impacts of their investments.

Staffing structure notwithstanding, building internal staff capacity is absolutely vital to plan and execute a thoughtful IMM strategy.

Diversity of Skills

The fund management team should have a diversity of skills. PE investments particularly rely on relationships, which team members must manage, and require nuanced expertise. The fund manager must regularly interact with key fund stakeholders, namely entrepreneurs, the board, and the board's committees. While LPs positively regard previous fund management experience, most equally weigh deal experience. So, while a manager needs skills in investing—both buying and selling—and operations management, they need not necessarily have achieved this experience as a fund manager. That is, LPs may also value experience as a direct investor or former entrepreneur. Depending on the fund's industry target, domain expertise can be critical.

Similarly important is PE experience in investment selection, management, and exit. Such experience could involve direct fund management, but could also involve corporate, operational, or consulting experience. Because financial management and reporting are crucial aspects of successful fundraising and capital deployment, financial and accounting expertise are also valued.

1.2.1.2. Integrating Impact Measurement and Management

One hallmark of impact investing is the commitment to measure and manage impact, known as impact measurement and management (IMM). IMM, which is integral to making effective impact investments, includes identifying and considering the positive and negative effects business actions have on people and the planet, and then determining the best ways to mitigate the negative and maximize the positive in alignment with impact goals. Successful IMM increases a fund manager's ability to demonstrate, articulate, and discern impact which, when communicated effectively, can mobilize more capital into the

fund. Many impact fund managers release yearly impact reports that demonstrate their mission-related performance.

Additionally, fund managers increasingly find that proper measurement practice can improve the management processes and investment decisions that drive financial, social, and environmental performance.

The foundation for successful IMM practice through a fund's lifecycle is laid in the early stages of fund design. One way to embed such practices is through impact-based incentive structures. A growing number of funds are attempting to improve commitment and accountability to their social mission by offering explicit incentives to staff to achieve social and environmental performance.

Besides incentivizing staff, impact investors can incentivize their investees to achieve impact targets, perhaps by making impact targets prerequisites to receiving capital (either follow-on capital or the initial investment), incorporating targets into the terms of the investment, or enacting governance changes if the targets are not met. Fund managers should, early in the design process, be aware of the possibility to codify these impact targets in legal documents, such as loan agreements, term sheets, LP and investor agreements, or private placement memoranda (to name but a few options).

1.2.1.3. Develop An Economic Model

Besides demonstrating the financial potential of its pipeline, a fund manager must demonstrate that it is a sustainable business capable of paying for its own operating costs. Fund economics, the capstone of the fund design process, integrates the important elements of the fund's structure and operating model, highlighting inter-dependencies and ultimately helping the fund manager make potential tradeoffs and decide whether or not a given fund strategy is viable. Fund design and operational modeling must culminate in a financial model that accounts for these costs, as LPs will look closely at a fund's economic model before investing, to ensure that it is credible.

A strong economic model is the main tool fund managers have to demonstrate how their investment strategy is viable and when and how their investors' capital will be deployed. A fund manager that cannot articulate a strategy for managing key fund features like management fees, carried interest, and capital deployment draws strong and immediate caution from investors. Furthermore, strong fund economics can help a fund better understand any potential internal inefficiencies in their capital allocation strategy and develop a more realistic approach to manage the flows of capital.

Three important considerations to remember when developing coherent fund economics are:

- Create a model that integrates all factors of fund management and investment strategy into the fund economics.
- Understand the interdependencies between the various factors.
- Given a limited budget, determine the best way to make the economics work.

Just as fund managers create financial models to evaluate their investees, they must create similar models to understand their own economics. Fund managers should be able to answer questions about the following core elements of their fund's economic model: fund size, investing returns, cash flow, operating budget, and deal instruments.

Fund Size:

- What is the expected capital commitments for the fund?
- What is the type and size of investments to be made?

Investing Returns:

- What are the projected returns for the fund (financial or social)?
- What are the expectations from investors (especially in case when fund is not planned to provide returns)?

Fund Cash Flow:

- What are the projected reflows of capital to the fund from investees?
- How are these reflows to be used?

Operating Budget:

- How much does it cost to run the fund?
- Is the management fee sufficient to cover these costs?

Deal Instrument:

- What type of deal instruments is the fund using?
- What are the projected loss rates for investments?

1.2.2. Marketing of the fund

After thoughtfully and thoroughly designing and structuring a fund, it is time to bring it to the market, to attract investors and begin investing. Fund marketing happens in discrete, strategic stages with various key activities occurring at each stage.

During the First Launch phase, a particularly important period, all the concept design and investor targeting takes place. First Launch activities include:

- Developing fund thesis and design;
- Identifying target investors;
- Finding an anchor investor, sponsor, or both;
- Determining and establishing an operational platform; and
- Preparing marketing materials.

Investor targeting, an essential step in the fundraising process, is initiated prior to launching a fund and approaching investors. This step will include discussion of:

- Investor types and landscape;
- Capital stacking and co-investment opportunities; and
- Understanding investor needs and interests.

Fund managers should not rely on a single, standard pitch or marketing approach. Targeting investors is an art that involves predicting which are more likely to say “yes” and knowing enough about how investors think and operate to make the best first impression. A fund manager must be both strategic and tactical, matching the fund’s thesis to that of their potential investors. A fund manager must be not only familiar with the vast landscape of potential investors, but also aware of the specific interests of different types of investor and how to appeal to these different interests through their marketing.

Fund managers and investors find each other in various ways, commonly the following:

- A request for proposal (RFP) process, wherein an Investor asks Fund manager to apply for investment from a specific pool of their capital. This process typically comprises a series of questions that cover most of the information that an investor would need in order to determine if a fund is a good fit for their investment strategy.
- investor driven: Some investors do their own research, reaching out to fund managers directly, and do not want to be contacted.
- Serendipitous connections: Investors and fund managers may meet through networking at events such as conferences or through referrals.
- Inquiries by Fund Managers to Investor's offices: A Fund Manager starts with a phone call or an email, sharing initial information with hopes of scheduling a face-to-face meeting.

In a grant-oriented fund, most likely investors will be public investors (European Commission and member states) willing to spend funds dedicated to support employment more efficiently, followed by philanthropic organizations and development agencies.

1.2.3. Managing of the fund

The worst thing a fund manager can do is not failing to raise capital but failing to effectively deploy it. LPs look for funds that demonstrate a clear pipeline of investments to continue throughout the lifecycle of the fund. A fund must demonstrate both its strategy for sourcing potential investee companies and its approach to ultimately selecting deals for investment. A fund manager must present a universe of opportunities to LPs that closely aligns with its fund's investment thesis, impact strategy, and risk-return objectives.

1.2.3.1. Definition of risk appetite

The management of the fund needs to regularly to agree on the risk appetite policy that reflects expectations and risk preferences of the investors. Initial risk appetite is defined in the course of the fund establishment, but it is advisable to reassess it periodically (annually) during the fund lifecycle in order to adjust to possible changing financial market conditions and investment environment in the selected fund's sector.

1.2.3.2. Deal sourcing and selection process

In order to source deals, funds must

(1) effectively market themselves and present their unique value proposition for potential investees and

(2) have a thoughtful strategy for identifying future investments.

On the first point, a fund's profile in the market and reputation greatly impacts the quality of its incoming inquiries and referrals. Having a strong local presence and business network is essential. Relationships with local stakeholders, support organizations, accountants, financial advisors, and those involved in supply chain management can all be important sources of deal flow.

On the second point, funds can take various approaches to pursuing potential deals. Some may pay for referrals or create formal partnerships with local incubators. The fund management team must be able to articulate a clear and sustainable strategy for identifying investees.

In total, a fund should plan to spend 12 months sourcing all deal, including time spent with the enterprise to ensure they are investment-ready. To maintain its pipeline, one fund, for example, records every conversation it has with a potential investable enterprise in an internal fund database. At the end of each month, a report is sent to the entire team detailing how many touch points each person on the team has had. The team member with the highest number of touch points receives a reward. While this is only one potential approach, all funds should find a model for tracking their deal sourcing and pipeline development that fits their DNA.

Networks, relationships, and partnerships with local intermediaries are all essential for developing a robust investment pipeline. Equally important is a well-established process for evaluating potential investments thoroughly and efficiently. Fund managers must also evaluate the impact potential of their investee companies and how that potential aligns with their own impact objectives.

Impact funds must consider how impact will be maintained after they exit an investment, in case of SIV funds, those are related to the number of employed people after the close of the fund or financial year of the fund and cost needed to achieve emoployment of one beneficiary.

If this cost is lower than the cost of other employment services provided and/or cost of social services provided to the unemployed person, it can clearly demonstrate its economic and social value.

1.2.3.3. Reporting

After investment, funds must provide transparent reporting on its relationships with portfolio companies to both its advisory committee and LPs.

Necessary reports should made available to investors in a timely fashion. For quarterly and annual reports, be ready with quarterly financial statements, regular portfolio reviews, and valuation reports.

The annual report, perhaps the most important, comprises:

- Annual audited financial statements;
- Annual environmental and social report;
- Summary portfolio update letter;
- Assessment and overview of impact performace;

In addition to formal and regular reporting to investors, establish strong relationships through regular informal communication, to keep investors close, preserve their likely involvement in future funds, and empower LPs to be ambassadors to other potential investors. Regular formal and informal communication with investors on a quarterly basis is best, but such communication can take different forms depending on the LP, including scheduled field visits to investees or informal quarterly meetings.