EUROPEAN VENTURE PHILANTHROPY ASSOCIATION

EXPERT ROUNDUP
Governance in VP/SI Funds

One of the main decisions to be made when setting up a venture philanthropy or social investment (VP/SI) fund is how to structure its governance.

Who should sit on the Board of the VP/SI organisation and how should they be involved? How to attract and manage the right funders? Who should make the investment decisions? How does governance evolve when new funders and investors come on board? This roundup summarises the lessons learnt of a group of experienced CEOs of EVPA full members.

Finding the right funders and investors and developing the perfect Board of Directors is key for the development of the VP/SI organisation – and one of the hardest elements to get right. Matching the investors with the DNA of the VP/SI fund is key because it facilitates decision making, and avoids costly, resource-intense and damaging misalignment. Choosing the right investors, who don't just have the money but also the right skills and experience, can develop the VP/SI organisation in the right direction, but is challenging and often there is a mismatch between the characteristics and skills of the investors and the boards they sit on.

Governance structures should lead to quick decision making and good planning. Having fewer people and the right kind of people who are available when decision-making times come is crucial.

When the first VP/SI funds were set up about ten years ago, governance was not a pressing issue. The funders were all private investors, who had equal voting and decision-making power and chose the strategy and investment. With VP/SI going mainstream, and the funds increasing in size, the number and types of investors participating in VP/SI funds has increased, making governance more complex and multifaceted.

The first stage is to make sure the new private investors understand the **functioning and the value of the VP approach**. Private investors who approach VP/SI coming from a personal experience in the private sector don't necessarily need much convincing, as they understand how investment works, hence the value of applying the principles of venture capital to philanthropic giving. However, these investors' return expectations need to be managed, as they might not be sufficiently used to deploy patient capital. Conversely, when the capital invested comes from families with a long tradition of philanthropic giving, often philanthropy and investment is split. For this type, there needs to be more done to integrate social investment into their life – the way to convince them to invest is to appeal to their values, so they want to integrate it in their philanthropic efforts.

Once private investors are on the Board, the challenge is to understand their needs and **manage expectations**. Some characteristics that seem to be recurring can help assess and manage private investors' expectations:

- Private investors will have **different levels of commitment**, which need to be accepted by the leadership of the VP/SI fund.
- When deciding where to put their money, private investors will be interested in seeing the **social impact** they are generating, so it is crucial to be able to show them an impact measurement system.
- Although being more risk-taker than other types of investors (such as institutional investors), private investors want **to understand what the risk is**.
- Private investors want to be part of a **network** (and they want the investee/grantee to be a part of a network).

Sometimes VP/SI organisations find private investors hard to work with, as it is hard to match the perspective of the investor and the needs of the funds and the investees. It is thus important to make sure that shareholders align behind the social mission and objective of a business and a set of indicators that will be reported on periodically. If such provisions are part of a shareholder agreement and become a legal document, transparency is ensured, and the relationship can work.

Recently, institutional investors have entered the VP/SI space more actively, and with more rigid **rules on the governance of the VP/SI funds** they deem elegible for receiving investment. Thus, more complex and sophisticated governance solutions have arisen. Hence, adding an institutional investor in the funding mix of a VP/SI fund can change the overall governance structure, as highlighted in the example in the box below.

For example, the EIF tends to look carefully at the governance structure of funds it invests in. Additionally, the EIF performs a deep due diligence on the management team, looking at its track record, finance, overhead, which serves as a quality statement to other investors and has been beneficial for some funds as it has pushed them towards better and clearer structures. Even though VP/SI organisations report working with the EIF difficult at first (because of the sizeable impact, amongst others, on their governance structures), they consider it worthwhile as, in return, EIF's approach gives management teams a great degree of operational freedom and independence in decision-making, once their governance structure provides for clear allocation of responsibilities and alignment of interest of all parties involved.

One VP/SI organisation was set up originally by six investors from five wealthy families. For the first two funds, all founders had equal say and they decided the strategy of the fund and made investment decisions together. For the third fund, the VP/SI organisation decided to engage with the European Investment Fund (EIF) as a co-investor as a step towards opening up its investment activities to an institutional investor community. EIF being a catalyst for institutional investment follows a thorough due diligence process which, amongst others, seeks to establish sound governance principles. These respect a clear segregation of duties between different stakeholders in the fund (and notably between the management of the fund and investors) and the alignment of interest between all parties involved. The resulting biggest change in the structure was represented by the increased decision-making power moved into the hands of the management team of the VP/SI organisation. The original founders could no longer decide at their discretion on strategy and KPIs, but became investors at the same level as the EIF. Hence, in Fund III the management team of the VP/SI organisation makes decisions on investments and divestments, and proposes the social impact KPIs (and target values). The VP/SI organisation still engages with the founders and its other investors, by way of an advisory board – which acts as a sounding board on investments, and provides help during due diligence. Hence no investor (private – the founders – or institutional – the EIF) can control the investment process or block investment or divestment decisions. The EIF was a sparring partner for the team in moving from the structure of the Fund I and II to that of the third fund. The VP/SI organisation reports its new structure being much more effective with clear allocation of responsibilities and alignment of interest, as team members are now shareholders, responsible for making investment decisions, which works better as they are close to the action. One lesson learnt is that investors should not be responsible for investment decisions.

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