Investor

This questionnaire can help you evaluate if you are prepared to invest in a Pay for Success (PFS) project.

PFS’s evidence-based policy approach addresses critical issues by interrupting cycles of negative social and economic outcomes to measurably improve communities and the effectiveness of public policy. Some PFS projects focus on scaling or replicating proven interventions, while others seek to introduce or adapt services to new settings. Issue areas that might be a fit for PFS include:

- criminal justice
- early childhood education
- homelessness
- prevention or treatment of problems associated with chronic disease
- substance abuse
- behavioral health
- workforce development
- and many more.

Pay for Success projects are sponsored by local, state, or federal governments that want to achieve better social outcomes by working with providers through service contracts that tie funding to outcomes. Investors provide the upfront money service providers need to deliver programs and achieve results. PFS investors can include:

- Private, corporate, and family foundations
- Commercial banks
- Community development financial institutions (CDFIs)
- Philanthropic intermediaries (such as the United Way)
- Institutional impact funds
- Donor-advised funds
- High net-worth individuals

Independent evaluators determine whether the target outcomes have been met at pre-determined intervals during the project. If the objectives have been met, the government repays the investors, sometimes with a return. Investors can support PFS in other ways, including funding field building and pre-launch development costs.

The questions below can help you assess if you are prepared to invest in a PFS project.

**Investment Role and Strategy**

PFS financing agreements are primarily structured as loans and, in a few cases, as equity investments. Most projects to date have involved multiple investors, and the most common arrangement is a layered capital stack with investments divided into senior and subordinate tranches differentiated by maximum return and/or timing of repayment. Investors taking a senior position tend to be commercial or private investors that make a larger investment and demand a higher risk/reward profile. Investors in subordinate position are usually philanthropists or CDFIs. The typical timeframe for repayment of principal and success payments is 4 to 6 years, but many projects deliver interim payments upon achieving specified outcomes.

- PFS can be applied in various ways to support social benefit. Are you interested in:
  - Using your financial expertise and access to capital to further social impact?
  - Scaling proven programs or programs with a high level of evidence?
  - Encouraging innovation in the social sector?

Continued
Investment Role and Strategy, cont.

- Have you identified issue areas or interventions that are most meaningful to your organization?
- Have you developed a strategy and policies and procedures for investments where the returns may be based on more than financial metrics?
- PFS’s “impact first” investors are primarily interested in social returns and/or supporting the development of the investment model. Do you prioritize financial returns and capital preservation over social returns?
- Is your organization comfortable with waiting 4 to 6 years for the majority of repayment and potential returns? Would you require interim payments?
- Most PFS agreements do not provide investors with short-term cash, liquidity, annual interest payments, or outsized returns. Does your investment policy allow for these features?

Risk

PFS projects support implementation of social services for high-need populations. Some of the risks inherent to these projects are well understood by the lending community, such as management risk, operating risk, interest rate risk, etc. However, many related risks can be difficult to quantify.

Social services outcomes can depend on a complex set of human, program implementation, and policy factors that vary based on geography and population served. There is no standard methodology for assessing these types of non-financial risks or for adjusting financial returns accordingly. Additionally, the evidence base for most social service programs is relatively small, and most current PFS projects have not been active long enough to provide a track record of expected results. Investors willing to assume risk are pioneering the field of PFS and the future of outcomes-based funding for social services.

- PFS agreements have been subject to much debate. Have you assessed the reputational opportunities and risks associated with PFS agreements?
- Are you comfortable with:
  - Participating in a new type of financing arrangement with limited established benchmarks or best practices?
  - Assessing outcomes that may be dependent on a complex set of factors outside of the providers’ control, including evaluation methodology, public policy, and program uptake?
  - Depending on government appropriations as a repayment source? Are there additional requirements you would place on government to mitigate your risk of repayment?
- Have you read existing PFS contracts to understand the issues and risks covered?
- Do you have capital available for investments with equity-like risk with modest financial returns?

Resources and Expertise

PFS agreements require significant time and senior expertise from participants, including investors. PFS projects often necessitate that investors do business differently, including working with the public and nonprofit sectors to negotiate complex multi-party contracts. In addition to dedicating internal resources, many PFS investors rely on external experts to provide services such as evaluating investment risk, structuring PFS deals, and negotiating financial and contractual terms.

- Do you have expertise in
  - Lending to or investing in social sector organizations?
  - Multi-year investments or commitments?
  - Assessing non-financial risk, such as political and reputational risk?
Resources and Expertise, cont.

- Are you comfortable negotiating with multiple parties with different priorities to craft mutually agreeable arrangements?
- Do you have the staff capacity or the external partners (e.g., program officers, investment officers, legal staff) to engage in the design and negotiation of the PFS financing documents over a period of 3 to 6 months?
- Do you have the capacity to actively manage your PFS investment to monitor implementation? Are you prepared to adjust contract terms in response to implementation risks?

This tool was originally created as part of the Rapid Suitability Questionnaires in collaboration with McKinsey & Company in 2012. In 2016, Nonprofit Finance Fund, with support from Third Sector Capital Partners and Social Finance, refreshed this resource to reflect market developments.