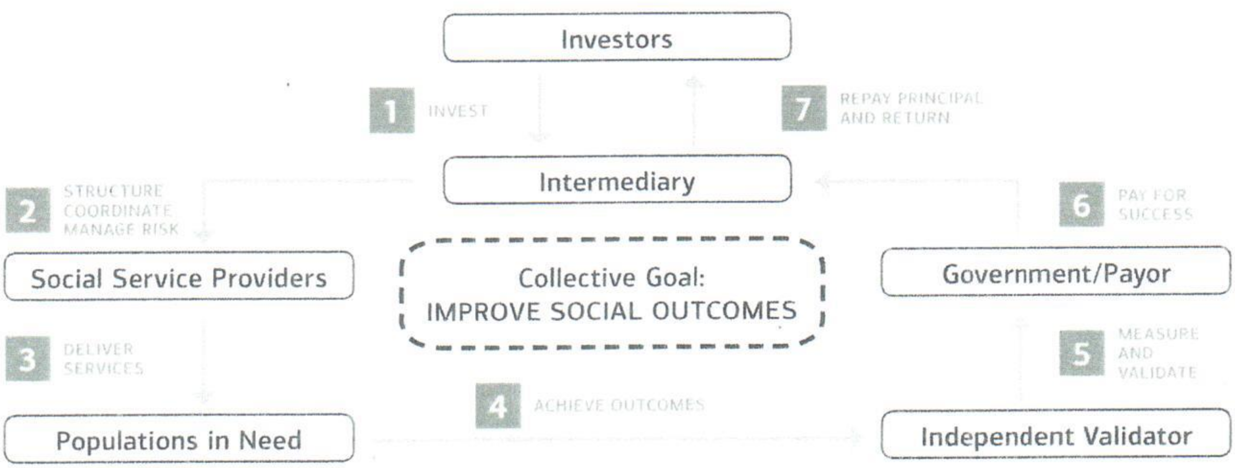
Pay-for-Success (PFS) Financing

Introduction

What is Pay-for-Success (PFS)[1] financing?

Pay-for-Success financing mobilizes private investment capital to expand the operations of highly effective nonprofit social service providers. An outcomes payor (generally a government body) commits to making performance-based payments to compensate investors, if and only if a rigorous evaluation of the program's results shows that the desired social outcomes were achieved.

Figure 1: Flow of capital in a PFS financing



Why do we need Pay-for-Success?

PFS addresses important social issues by directing capital to programs with a track record of success. Its value proposition rests on two key observations.

- Highly effective social service providers have the capacity to generate meaningful value for various stakeholders, yet they are often underfunded and serve only a fraction of potential beneficiaries. Vulnerable individuals without access to these programs often require expensive safety-net services, which results in higher costs for both government and society.
- At the same time, growing demand from investors for investment options that reflect their values creates a need for financial products that actively create positive social impact.

PFS financing represents a unique solution, creating an uncommon partnership in pursuit of common goals. Ultimately, PFS helps service providers meet the needs of underserved populations while enabling government to direct funds to what works, and investors to pursue social as well as financial investment goals.

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This presentation is co-authored by Merrill Lynch and Social Finance.

SOCIAL FINANCE

[1] Pay-for-Success financing is also known as a Social Impact "Bond," Social Impact Partnership or Social Impact Financing.

What are the critical tasks to execute PFS financing?

Executing PFS financing requires the completion of a series of critical activities summarized below. While these activities are listed in relative order of operations, many may occur in parallel.

- **Market development:** Provide general market education, thought leadership, research, advocacy and analysis to support the development of a robust and sustainable PFS financing market.
- **Supply creation:** Identify high-potential issue areas. Develop and pass enabling legislation (if needed). Advise on, initiate and participate in formal procurements, including selection of candidates (service provider[s] and/or intermediary) for inclusion in PFS projects.
- **Due diligence:** Identify and vet high-potential interventions, including initial assessment of evidence and economics; find, evaluate and engage suppliers of social services and/or intermediary services with capacity to deliver outcomes for a target population. Examine social services provider(s) against alternative options before making a selection. Key aspects include evaluating the organization's evidence base and track record, ability to collect data, operating model and outcomes, cost effectiveness and potential return on investment (ROI), and leadership team.
- **Service provider selection:** Choose the social services provider(s) best suited to achieve the selected outcomes for the target issue area and population in the given jurisdiction.
- **Mobilization:** Bring together all stakeholders to design, structure and negotiate a transaction. Manage deal to shared timeline and contract provisions.
- **Program design:** Design and structure key project components, including details of service provision to specific target populations and geographies, service delivery timeline, duration and intensity of services, and evaluation design.
- **Structuring:** Develop investment structure and term sheet, including outcomes pricing, capital structure and payment schedule.
- **Negotiating:** Discuss and finalize key economic (investment structure, pricing, payment scheduled) and contract (termination, appropriation, duration, representations, etc.) terms. Draft key contracts between stakeholders.
- **Documentation:** Finalize all contracts and supplementary documents, including offering and/or loan documents as relevant.
- **Capital raise:** Market the transaction to investors and attain required capital commitments necessary to fund the given project and related transaction costs.
- **Operations:** Ramp up and deliver social services per the program design.
- **Monitoring:** Actively monitor key program milestones, analyze interim program and outcome data as available, problem-solve, and make real-time course corrections if needed.
- **Investor reporting:** Inform investors of project progression, including overview of the program to date, key milestones, course corrections required and analysis of interim operating data. Provide investors with timely and relevant financial and tax-related reports as required.
- **Measurement:** Measure success of program per evaluation design, calculating payment (if any) due to investors.
- **Payment:** Provide outcome payments to investors upon determination that payment is due, according to the relevant contract terms.