



# **INNOVATIONS IN FINANCING STRUCTURES FOR IMPACT ENTERPRISES: SPOTLIGHT ON LATIN AMERICA**

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#### **About the Multilateral Investment Fund**

The Multilateral Investment Fund (MIF) is the innovation laboratory of the Inter-American Development Bank Group. It promotes development through the private sector by identifying, supporting, testing, and piloting new solutions to development challenges and seeking to create opportunities for poor and vulnerable populations in the Latin America and Caribbean region. To fulfill its role, the MIF engages and inspires the private sector and works with the public sector when needed. Created in 1993 by 21 donor countries, the MIF is the largest provider of technical assistance for private sector development in Latin America and the Caribbean and has financed more than US\$2 billion in grants and investments for private sector development projects through more than 2,000 projects.

#### **About the Rockefeller Foundation**

The Rockefeller Foundation's mission remains unchanged since 1913: to promote the well-being of humanity throughout the world. Today, the foundation pursues this mission through dual goals: advancing inclusive economies that expand opportunities for more broadly shared prosperity, and building resilience by helping people, communities, and institutions prepare for, withstand, and emerge stronger from acute shocks and chronic stresses. To achieve these goals, the Rockefeller Foundation works at the intersection of four focus areas: advance health, revalue ecosystems, secure livelihoods, and transform cities. It works to address the root causes of emerging challenges and to create systemic change. Together with partners and grantees, the Rockefeller Foundation strives to catalyze and scale transformative innovations, create unlikely partnerships that span sectors, and take risks others cannot.

#### **About Transform Finance**

Transform Finance is a field-building nonprofit organization working at the intersection of finance and transformative social change. It informs, organizes, and supports a variety of stakeholders in impact investing and beyond to ensure that capital is deployed in ways that are beneficial to communities. It convenes the Transform Finance Investor Network, a community of practice for investors that have committed US\$2 billion to be invested in accordance with the principles of community engagement, non-extractiveness, and fair allocation of risks and returns. Transform Finance supports the broader field via thought leadership, briefings, convenings, and advisory services. For more information visit [www.transformfinance.org](http://www.transformfinance.org).



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## PREFACE

### ELIZABETH BOGGS DAVIDSEN

*Head of Knowledge Economy, Multilateral Investment Fund*

For more than 20 years, the Multilateral Investment Fund (MIF) has provided broad support to small and medium enterprises. More recently, over the past 18 months, the MIF has been experimenting more directly with new ways to deploy its mixed toolkit of grants, equity, and debt to better meet the needs of small and medium enterprises, particularly impact enterprises that seek to address social and environmental needs, and which struggle to access appropriate capital.

Through our experience we have noted that meaningful barriers to financing still exist, including risk-averse local banks, misaligned investor expectations, high transaction costs, longer time horizons, limited assets, and small enterprise size. To get at the root of these issues and develop some actionable steps, we developed an ongoing collaboration with Transform Finance. This work included a series of workshops on new financing structures in January 2017 at the Inter-American Development Bank in Washington, D.C. and in February 2017 at the Latin American Impact Investor Forum (FLII) in Mérida, Mexico, that brought together more than 70 experienced practitioners.

Together with the Rockefeller Foundation, we continued this exploration during our jointly organized Global Summit on Social Innovation in Bogotá, Colombia, in March 2017. The 120 selected participants represented those who are working to achieve breakthrough solutions to serious societal challenges: innovation labs, accelerators, and incubators working to consolidate and scale impact enterprises as well as intermediaries working to finance, accelerate, and measure social impact. From the workshops and Global Summit emerged a broad consensus that new solutions were needed to increase the flow of

appropriate capital to pioneering entrepreneurs and that funders (development banks, foundations, and impact investors) should innovate in the types of financial instruments they offer.

Innovative financing mechanisms are a key element of the system-building activities that have been core to the MIF's work and we are pleased to present this report, **Innovations in Financing Structures for Impact Enterprises: Spotlight on Latin America**, as a step forward in developing the field. The report includes the views gathered from the 2017 workshops and Global Summit, as well as from interviews and focus groups that were carried out from March to June 2017 to identify and document a range of new and alternative financing structures to address funding barriers. Many of the structures presented in the report have been piloted in the MIF's 2016–17 portfolio of approved projects. The Rockefeller Foundation has provided thought leadership on the content and cases.

Our collective goal in producing the report is to share current best practices and existing examples in the design and implementation of innovative approaches and alternative structures to encourage replication and collaboration, as well as to increase the flow of funds to impact enterprises in emerging markets. We are delighted to lead this work and to include the new models that the MIF is funding as a show of our commitment to and interest in wider field-building and investment.

We see this work as a starting point and the recommendations that emerged from the study provide some guidance on next steps and further collaboration and experimentation that we will continue to support.

# 1. Introduction

Much like the rest of the world, in recent decades Latin America has experienced a dramatic increase in enterprises that seek to address social and environmental needs in addition to making profits. The unique characteristic of these “impact enterprises” is the expectation of a net positive social or environmental benefit, whether through their product or service, or because of the way in which they create value for the communities they serve.

Despite solid financial statements and demonstrable contributions to the economy and to society, many impact enterprises find it challenging to obtain capital that aligns with their needs and characteristics and enables their development and growth. This is particularly the case for impact enterprises in the early and growth stages. Much of this applies to traditional enterprises as well and not necessarily to all impact enterprises. Many of these impact enterprises are unlikely to meet the return requirements of traditional private equity investors, or the risk mitigation requirements of traditional debt providers such as banks, and in consequence do not survive past the seed and early stages of financing—the phase known as the “valley of death”—due to a large number of business development challenges.

The financing gap for early and growth-stage impact enterprises has been well analyzed. Building on that foundational analysis, this report focuses specifically on the opportunity to capitalize the enterprises via alternative financing structures that go beyond traditional debt and equity and are especially

well suited to the variety of markets, sectors, and conditions in which impact enterprises operate. The Multilateral Investment Fund (MIF) has been supporting the development of alternative financing structures to increase the menu of opportunities available and overcome this challenge.

## PURPOSE OF THIS REPORT

Growing interest in the financing needs of impact enterprises has given rise to meaningful experimentation in deal structuring and the emergence of some early good practices among entrepreneurs and investors.

Three clear trends have emerged:

- A growing appetite for different forms of capital,
- An emerging marketplace of innovation in financing structures, and
- An increasing need to do more.

The Transform Finance/MIF partnership prepared this report to foster the flow of more capital that is adequate for early and growth-stage impact enterprises in light of these trends. The research and exploration done for the report was supplemented with direct engagement with fund managers, asset owners, and impact entrepreneurs to ensure its applicability to their work.

## THIS REPORT PROVIDES AN OVERVIEW OF THREE MAIN AREAS OF INQUIRY:

### DOCUMENT THE NEED

Review the reasons why traditional debt and equity capital may not fit the needs of impact enterprises and explore how alternative financing structures may be better aligned.

### POINT TO SOLUTIONS

Describe some of the alternative financing structures that have emerged as promising models, for both investor deals and bank financing, accompanied by case studies.

### PAVE THE PATH

Provide initial recommendations for what can be done to foster more widespread adoption of alternative financing structures.

## IMPACT ENTERPRISE FINANCING IN LATIN AMERICA

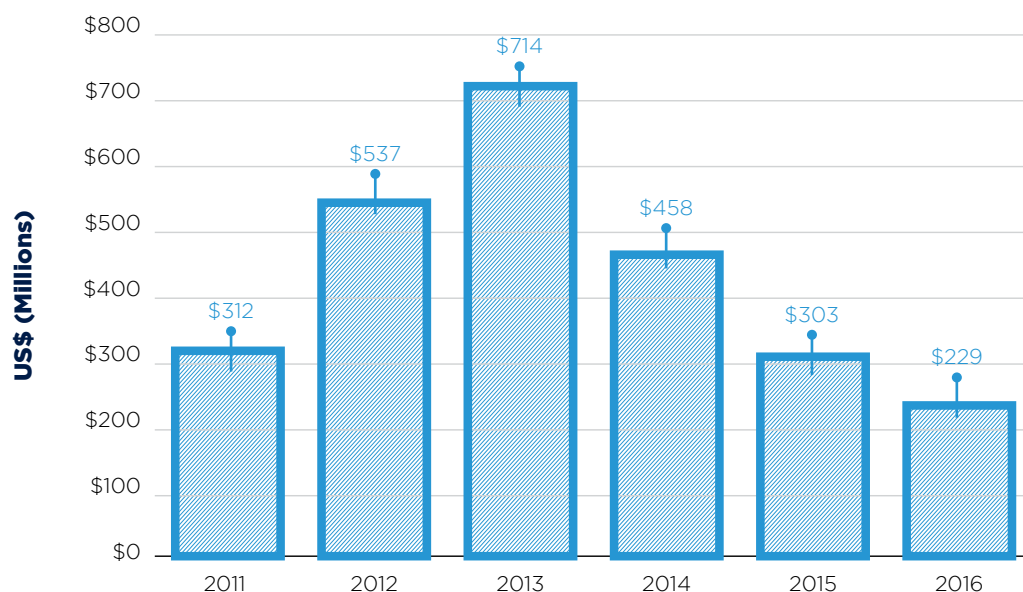
Latin America boasts an active market in impact investing and its growth has been remarkable, expanding from US\$160 million in 2008 to over US\$2 billion in 2013.<sup>1</sup>

The capitalization of promising impact enterprises in Latin America is often synonymous with early-stage equity financing via private equity venture capital.<sup>2</sup> While still in its early days compared to its long-standing use in the United States, early-stage equity financing has demonstrated potential to benefit the regional economy. Companies backed by venture capital have contributed to remarkable performance and economic growth and have become engines of job creation, both through direct employment and by stimulating growth and employment among their local suppliers. They have contributed to the development of more active capital markets and to an increase in tax revenue for their host governments.

However, in most Latin American countries, venture capital has funded only a relatively small number of companies with a social mandate. According to multilateral institutions operating in the region, most capital is concentrated in low-risk investments, particularly at later stages of the enterprise. For the estimated 70 percent of impact enterprises that are in early stages and pre-profitability, little appropriate risk capital is available.

One opportunity to increase early-stage financing is, not surprisingly, to increase the amount of venture capital available in the region. Another option, explored as part of this report, is the support and development of alternative forms of capital that may be able to complement venture capital flows, in particular for the high percentage of promising companies for which venture capital funding, as traditionally structured, may not be the best fit.

## VENTURE CAPITAL FUNDRAISING IN LATIN AMERICA, 2011-2016



Source: LAVCA Industry Data & Analysis, 2017.

<sup>1</sup> Bain & Company (2014), "The State of Impact Investing in Latin America," <http://www.bain.com/publications/articles/the-state-of-impact-investing-in-latin-america.aspx>, accessed July 2017.

<sup>2</sup> For the purposes of this report, private equity venture capital, or simply venture capital, refers to the practice of providing financing to early and growth stage enterprises via equity investments.



Limited data are available on the presence and performance of venture capital for impact investing in the region. The Latin American Private Equity & Venture Capital Association (LAVCA) reports an aggregate of US\$2.55 billion raised by venture capital funds in the region between 2011 and 2016, but there are no disaggregated data for impact investing funds. By way of comparison, venture capital in 2014 represented 1.23 percent of gross domestic product for the United States but only 0.12 percent for Brazil,<sup>3</sup> the giant among venture capital markets in Latin America.

Beside the amount of capital deployed, it is instructive to look at the number of exits for investors in the region, taking the exit as the indicator of success for the equity investor. In 2015, Latin American venture capital funds realized US\$30 million in exits (LAVCA 2016)—including both impact and non-impact deals. On the impact side, the Global Impact Investing Network (GIIN) reports only 18 exits by equity impact investors in the region between 2010 and 2016.<sup>4</sup> With thousands of potentially flourishing impact enterprises in the region, the dearth of sought-after exits gives pause.

Investors committed to the development of the impact enterprises in the region acknowledge the problem. They view the “lack of appropriate capital across the risk/return spectrum” as the key constraint to the growth of the impact investing market.<sup>5</sup> In the region, as elsewhere, too many companies find themselves stuck in the valley of death.

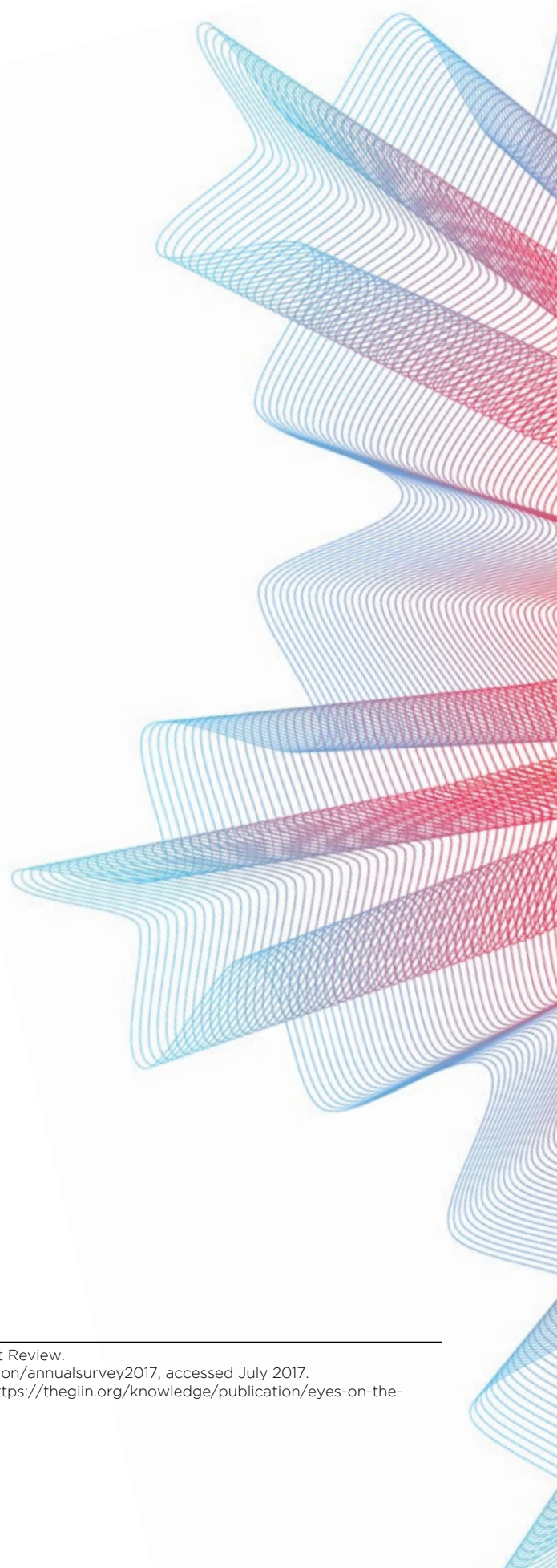
Given both the great need and the fervent activity in impact enterprise in Latin America, it is unlikely that even dramatic growth in venture capital activity could adequately capitalize promising enterprises.

It is within this framework that an exploration of alternative deal structures for the region becomes especially worthwhile.

3 EMPEA, Emerging Markets Private Equity 2014 Annual Fundraising and Investment Review.

4 GIIN, Annual Impact Investor Survey 2017, <https://thegiin.org/knowledge/publication/annualsurvey2017>, accessed July 2017.

5 GIIN and J.P. Morgan (2015), “Eyes on the Horizon: The Impact Investor Survey,” <https://thegiin.org/knowledge/publication/eyes-on-the-horizon>, accessed July 2017.



## 2. The Need for Alternative Deal Structures

The term “impact enterprise” is intentionally vague. It refers to companies that seek to address a social or environmental problem, either through their product or service, such as renewable energy companies or financial inclusion providers, or through structural features, such as worker cooperatives or companies that employ marginalized individuals.

The breadth of the term makes it hard to generalize. Some impact enterprises may grow and be extremely profitable. Others may more closely resemble nonprofit organizations. It is precisely the sweeping range of contexts in which they operate that requires the deployment of a broad and innovative capital toolkit. Impact enterprises can range from a large scale water distribution system in Lima to a local food hub in Puebla: it is unlikely that all would be best served by funding on the same investment terms that were used to fund Snapchat, Instagram, or Uber.

Despite their differences, impact enterprises tend to share some characteristics, from challenging operating environments to a focus on mission that can at times be at odds with rapid growth. This section highlights several reasons investors and entrepreneurs raise regarding why traditional debt and equity structures are unable or not ideally positioned to meet the capital needs of impact enterprises. While these may not be applicable to all impact enterprises—and may also apply to traditional enterprises—there is a broad consensus that they are especially salient in impact enterprise financing.

### INVESTOR CHALLENGES

#### HIGHER PERCEIVED CREDIT RISK

In the debt financing context, banks and other debt providers almost universally require collateral to offset the loan risk. Many impact enterprises lack collateral and most do not have established relationships with banks, which can also help assuage concerns about risk. The providers are therefore understandably cautious about lending to impact enterprises, limiting the availability of loans. In addition, the particular markets and models of impact

enterprises are generally unfamiliar to banks, which reduces the likelihood that they will lend. Finally, even where loans are available, banks may see debt service as an added risk with impact enterprises, whose cash flow may not match traditional debt repayment schedules and whose risk profiles can result in high interest rates that can further hinder repayment.

#### LOWER POTENTIAL RETURNS

The expected financial returns of impact enterprises can be unappealing to many equity investors. In part this is because such enterprises tend to address market failures or areas where entrepreneurs purely seeking returns have not engaged. As a corollary, impact entrepreneurs often face a trade-off between impact and profitability. In a context where even impact investors are looking for venture capital-like “home runs” and market-rate returns on early-stage and growth-stage equity, most equity investors eschew enterprises that could deliver high impact, but, despite their overall financial viability, could not deliver high financial returns. This leaves unfunded a major slice of the investable universe of impact solutions.

#### LONGER TIME HORIZONS

Equity investors who are expecting meaningful returns in five to seven years may be disappointed with the performance of impact enterprises, which often address complex problems in complicated markets that can slow business development. Moreover, their business models may be untested and the time to achieve profitability—as well as to achieve impact—is often longer than for traditional enterprises. Similarly, traditional debt providers, such as banks, may not be able to match their timelines to those of the enterprise. This is especially the case where the product intrinsically requires a longer time to reach maturity, as for agroforestry businesses where the time to harvest can be 10 or more years.

#### HARDER AND SLOWER PATH TO SCALE

In terms of scale, equity investors’ aspirations for rapid growth do not align well with the realities of impact enterprises. In some cases, the enterprise may grow more slowly, in others, it may simply be

unsuited for scaling up. The tendency of equity investors to push companies to grow and scale up quickly may, rather than supporting rapid success, instead push impact enterprises faster toward failure.

## FEWER EXIT OPPORTUNITIES

Barring an unlikely initial public offering, the traditional equity exit comes from a merger or acquisition. However, many impact enterprises operate in social sectors where there are fewer merger and acquisition events, apart from a few notable exceptions such as in the medicine and health-tech sectors. This lack of a vibrant merger and acquisition environment—whether as a matter of market or of sector—is itself a deterrent for a typical equity investor. With few exit opportunities, there is also an inherent risk of pushing toward an exit to a buyer that is not aligned with the mission of the enterprise and is likely to compromise its impact goals.

## HIGHER TRANSACTION AND OTHER COSTS

Transaction and other costs are comparatively higher for investors in impact enterprises, considering the need for added resources related to impact measurement and monitoring, finding appropriate exit opportunities, and recruiting talent that understands the niche of impact businesses. Other peculiarities of impact enterprises—from their unique market positioning to the lack of established banking relationships—also make for higher transaction costs, which decrease the relative availability of capital. Not unlike traditional early stage enterprises, the transaction costs for impact enterprises are also relatively higher due to the typically smaller size of deals.

## ENTREPRENEUR CHALLENGES

While all early-stage enterprises can struggle to access capital, in many ways impact enterprises face additional hurdles in obtaining financing. This section highlights a few of the obstacles that are most relevant to impact enterprises—without claiming that they are applicable to all.

Impact enterprises, by their nature, differ in goals and aspirations from traditional enterprises. They may view financial returns as a means to sustainability rather than an end in themselves. They may address local challenges without a view toward replication and continuous quest for scale. From the perspective

of capital being at the service of the enterprise, impact entrepreneurs and their funders highlighted several characteristics and challenges.

## LONG-TERM COMMITMENT TO ENTERPRISE

Many impact entrepreneurs intend to see their companies grow organically over the long run and do not prioritize rapid growth. Since an enterprise with less pressure to rapidly increase the value of its shares is intrinsically less attractive for equity investors, impact entrepreneurs not focused on growth find it especially difficult to access equity financing.

## LESS EMPHASIS ON EXITS

Impact entrepreneurs, rather than looking for an exit, may want to hold on to a business and benefit from its cash flow. Concerns about community jobs or the provision of local services in the case of an exit also militate against taking on the type of financing that could result in a departure of the company from its original community roots.

## COMPLEX OPERATING ENVIRONMENTS

The inherent quest of serving traditionally overlooked market segments (whether low-income, rural, or base of the pyramid) can push impact enterprises to be innovative in terms of product design, distribution channels, or even segmentation strategies with cross-subsidies. This approach can increase risk without a corresponding increase in potential returns.

## CONCERNS ABOUT PRESERVING THE MISSION

Bringing in equity investors with traditional return and timeline expectations may be unattractive to the entrepreneur, as it may be associated with loss of continued governance over the business mission and pressure to favor profitability that may be inconsistent with the mission. This is particularly the case where an impact enterprise provides goods or services that cater to populations that differ in their needs and their ability to pay.

## HIGH COSTS OF FAILURE

Since impact enterprises address social or environmental challenges, their failure may have significant implications in the social conditions of

their clients and the environment. The consequence of a potential failure in most cases goes beyond the enterprise itself and can have tangible negative impacts upon the communities it has been serving.

## ADDRESSING THE CHALLENGES

The potential mismatch of traditional debt and equity to impact enterprise capital needs does not mean that these enterprises must remain unfunded. It simply means that they—as well as the investor community—would often benefit from looking beyond traditional deal structures.

### THE RISE OF ALTERNATIVE DEAL STRUCTURES

A universe of alternatives between the poles of debt and equity already exists, with a continuum of instruments that mix and match elements of traditional debt and equity in ways that can lead to deal structures that are tailored to financing impact enterprises. Recent years have seen an increase in experimentation in Latin America, particularly around flexible debt instruments and revenue-based loans that offer some equity-like gains. A community of investors has emerged who prefer smoother returns via a clear path to progressive liquidity, rather than a quest for less likely, but higher, return multiples.

Alternative deal structures based on debt and equity terms are in many ways similar to traditional financing: they are suitable for a range of risks and returns and are often encountered in contexts other than impact investing. Regardless of their specific traits, they are generally based on a return to the investor that is derived from a percentage of revenue, or another financial indicator, such as free cash, up until a multiple of the original investment is reached. They can also be used as one-off structures or a portfolio of investments.

A bigger departure from traditional financing is in the innovations around alternative grant structures. These require the participation of a philanthropic investor yet, unlike traditional grants, they can include investment terms borrowed from debt and equity structures.

Despite their differences, all these structures hinge on a return to the investor that is not contingent on a hypothetical future liquidity event, such as a merger or an acquisition.

The choice among these structures, from the investor's perspective, is generally based on the stage of the enterprise, its cash flow potential, expected time to profitability, potential exit opportunities, the need for downside protection, and the investor and entrepreneur preference between debt and equity (including tax considerations). As a general matter, revenue-based loans are more suited for circumstances where there is some visibility into when the company will be profitable and the potential return to the investor is to some extent predictable. Revenue-based equity structures, like their straight equity counterparts, tend to be more suited for early-stage investments, with which they share the unpredictability of the returns.

The main features of alternative deal structures are described in chapters 3 and 4. Chapter 5 describes the features of alternatives to closed-end funds. Case studies of the various alternative deal structures are at the end of the report.



### 3. Alternative Structures in Debt and Equity

#### DEBT CONTINUUM: REVENUE-BASED LOANS

Alternative debt instruments allow for higher levels of risk, often compensated by higher potential for gains. In their application, they are suited to growing companies that are already profitable or have a clear horizon for profitability. Generally, these debt instruments require the company to make periodic payments based on a percentage of revenue, profit, or other financial indicator, up to a predetermined return on investment. Compared with traditional debt instruments, they tend to be more flexible in their timelines, including significant honeymoon or grace periods, and less reliant on collateral. Other loan models combine flexible repayment schedules with upside incentives.

Alternative debt instruments tend to add features onto a traditional debt structure. These can include flexible payment schedules with holidays and grace periods, the calculation of repayment amounts as a percentage of revenue or of cashflow, and enhancements such as royalties. The common element of these instruments is the lack of a time frame for repayment and the lack of a maturity date for the loan: repayments continue until the multiple is reached.

Revenue-based loans align the needs of both company and investor. The company benefits from not having to make periodic payments at a pre-established amount. The investor benefits from the success of the company. Unlike in a traditional loan, the investor assumes an additional risk if revenue falls below expectations, which extends the time of repayment. Some investors have protected against

this risk by determining repayment amounts as the higher of actual or projected revenue.

While investors see some risk in relying on the company's future earnings rather than on collateral, revenue-based loans allow investors to see early results from the investment instead of waiting for a third-party exit, as in a traditional equity deal. In that sense, a revenue-based loan offers a predictable cash return, but an unpredictable repayment period. In general, investors expect a revenue-based loan to be repaid up to the multiple within 4 or 5 years from the initial investment—which is a preferable circumstance to the longer waiting period for a (speculative) equity exit.

By their structure, revenue-based loans have an upper constraint on returns in terms of multiple of investment. Several variations have emerged that recognize the additional risk taken as compared to a traditional loan. In some cases, a revenue-based loan can feature a straight interest rate that is enhanced with a “royalty kicker”: a percentage of revenues payable to the investor on top of the straight repayment, or an option to convert to equity.

Another variation is the demand dividend, a variable payment obligation that accommodates the seasonality of revenue for many impact enterprises, particularly agricultural businesses. It is structured as a debt instrument, with variable payment for both principal and interest, usually calculated based on free cashflow. To provide some potential gain as a risk premium, this instrument often includes a conversion option and participation rights in future rounds of funding.

The following are some emerging structures within the revenue-based loan category:

- Straight revenue loans in which a percentage of revenue is repaid periodically up to a multiple of investment;
- Convertible revenue loans in which a percentage of revenue goes toward repayment, with the remainder convertible to equity;
- Subordinated debt with the returns from periodic repayments potentially enhanced by a percentage of revenue or by warrants.

## EQUITY CONTINUUM: REVENUE-BASED EQUITY INVESTMENTS

The alternative equity models incorporate predetermined liquidation mechanisms: the investor's exit is structured, rather than relying on an event such as an acquisition or initial public offering. For example, the deals can be structured so that investors can sell shares back to the company at fair market value or based on a predetermined formula. These redemptions can take place at the end of the investment period, or the equity stake can be redeemed gradually. Another emerging equity structure builds in dividends and distributions to investors based either on cash flows or on a percentage of revenues or profits. In these dividend and distribution deals, the company commits to making distributions to the investor until a target is achieved.

## REDEMPTIONS

Redeemable equity is similar in its terms to traditional equity, except for the inclusion of a feature providing for the company to repurchase the investor's stake—essentially, the investor's exit is back to the company, not to another equity investor. The redemption price can be left open and negotiated at the time of exit (for example, by bringing in a third-party valuation), or can be a predetermined multiple of the original investment price.<sup>6</sup>

A common way to implement the redemption is through mandatory repurchase of the shares via a percentage of revenue set aside over time. In this arrangement, the repurchase of shares is contingent on the company having built a sufficient redemption pool. At the investor's discretion, the redemption pool is to be used to redeem, on a periodic basis, as many shares as possible at a predefined multiple of the original purchase price.

A redemption can also be implemented through recapitalization of the company. Once the company is profitable enough to attract more conventional financing, the investor can trigger a redemption that would require the company to seek lower-cost capital (such as traditional debt) and use that capital to buy shares back over time or in one event. Redemptions that take place on a progressive schedule offer the investor faster partial liquidity and reduce the company's outstanding obligation upon a future equity financing round.

While redemptions may be made mandatory, redemption provisions typically offer some flexibility in the event the company lacks the cash to fulfill the redemption. In impact investing, regardless of a flexibility provision, an investor may be hard pressed to execute the redemption if it would mean putting the company out of business.

One-time redemptions after an agreed-upon period can be used by investors as an optional right to generate a primary source of liquidity, or can serve as a secondary mechanism to force a return of capital if a sale or initial public offering does not occur within a certain period.

Overall, redeemable equity allows for equity-like terms without the need for a liquidity event. Like a traditional equity instrument, redeemable equity does not provide any recovery to the investor in case of bankruptcy, which is a possibility with a revenue-based loan. Unlike a traditional equity instrument,

<sup>6</sup> An equity redemption with a predefined multiple is both a floor and a ceiling with respect to the amount of money that is returned to the investor. The internal rate of return, however, depends on how quickly the company sets aside the redemption pool.

however, a revenue-based equity instrument will likely have recovered some of the invested capital during the life of the investment prior to a bankruptcy event. Depending on the terms of the stock purchase agreement, a revenue-based equity investor may enjoy some additional gains if the company is acquired before the redemption has been completed.

## MANDATORY DIVIDENDS

Similar to a preferred equity model, under a mandatory dividend structure the company pays the investor a percentage of profits in the form of a dividend for a specified period, or until a target is achieved. At the end of that period, the company repurchases the underlying shares, generally at the price of the original investment. The redemption of the underlying shares can also be set at a predefined moment to the extent there is an unpaid portion of the total obligation due.

Dividends offer partial payments to the investor, generally based on measuring the company's financial performance. As a technical matter, a dividend is issued by the company's board and is not contractually guaranteed. This requires the investor to pay additional attention to matters of governance.

When calculated based on financial performance, dividend payments are intrinsically variable: the return to the investor is directly tied to the well-being of the enterprise. The variability avoids the burden on the enterprise that would come from predetermined repayments during low revenue periods.

Dividends are typically capped at a multiple of the original investment. But those that are established for a specified period create a significant opportunity for gains if the company outperforms. As in the redeemable share structure, there is also an

opportunity for gains with a traditional exit, such as an acquisition, where the underlying shares that have not yet been redeemed, rather than being repurchased at the original investment price, would be purchased by the acquirer at the same price as all other shares.

Some investors have offered a grace period to defer the initial dividend payment. Grace periods are useful to provide the enterprise a chance to reach efficient scale, particularly in the case of early-stage investments.

A structure that resembles a mandatory dividend is a cash flow split, where all distributable cash (per a predetermined methodology) goes to investors until the principal is repaid or a target is reached. In the case of a principal-only distribution, after the principal is repaid, the investor is entitled to a pre-established share of distributable cash. Such distributions can be made subject to the board's decision, for example, to reinvest the cash into the enterprise.

The following are some emerging structures within the revenue-based equity category:

- End-of-period equity redemptions in which shares are redeemed at the end of the investment period, such as by a mandatory repurchase at year X using a third-party valuation;
- Gradual equity redemptions in which shares are redeemed gradually over the investment period, at a predetermined price and frequency based on a cashflow set-aside for periodic redemptions;
- Percentage-based dividends in which the board issues a dividend based on a percentage of profit, until a multiple is reached, and repays the underlying shares at their original price.

The case studies along the continuum of debt and equity are listed in the table below.

### CASE STUDIES ON ALTERNATIVE STRUCTURES IN DEBT AND EQUITY

<b>Enclude</b>	Variable Payment Obligation
<b>Village Capital</b>	Revenue-Based Loan with Royalty Component
<b>La Base/The Working World</b>	Flexible Debt for Worker-Recovered Companies
<b>Adobe Capital</b>	Revenue-Based Mezzanine Debt
<b>Eleos Foundation</b>	Demand Dividend
<b>Inversor</b>	Combined Redeemable Equity and Variable Debt
<b>Acumen</b>	Self-Liquidating Equity Structure for Investing in Cooperatives

#### Applying Alternative Deal Structures across a Portfolio

Alternative deal structures can be used across a portfolio of investments that is set up as a traditional closed-end fund. This approach allows the fund manager to have a broader set of structures available, while keeping a fund structure that is relatively familiar to potential limited partners. The application of alternative deal structures across a portfolio can serve to diversify strategies and risks and can provide the fund with access to additional portfolio companies that were previously considered out of reach. The fund manager may reserve the option to invest along traditional debt and equity structures.

Adobe Social Mezzanine Fund I, a debt-equity continuum alternative, is an example of such a fund and is structured as a 10-year closed-end fund. It has shown that the revenue-based mezzanine debt structure works well even when rolled up at the fund level.

NESsT's continuum of debt instruments is an example of alternative deal structures that are intentionally built into the fund's model: a certain percentage of the investments will go to soft loans, and the rest to traditional debt or convertible debt instruments.



## 4. Alternative Structures in Grants

Providers of philanthropic capital to impact enterprises have long wrestled with the fact that they may be subsidizing enterprises with the potential to be financially successful, without capturing any of the potential gains. While the philanthropic investor may be especially keen on the impact generated by the enterprise, efforts to recoup those investments when financial success results are compelling, even if only to enable the recycling of the capital to a new batch of impact enterprises. Conversely, investors have also acknowledged that in many cases the achievement of impact comes to the detriment of the financial returns of an enterprise. In such cases, they may intentionally seek to subsidize the financial returns to achieve the impact in order to crowd in capital that will not distort the impact mission.

The alternative grant instruments differ from traditional donations in that they embed the possibility of repayment: a recoverable grant could be repayable if an enterprise secures a next round of financing, or for not having achieved an impact sought. As such, they are an opportunity to participate in the profitability of an enterprise, in the case of commercial success, or recoup the

investment, in the case of a failure to meet an impact threshold: the investor providing a grant with a recovery option has the intention to recover the capital or principal while sharing the risk of failure; the investor providing capital that is forgiven upon the achievement of an outcome (a “do not pay for success” grant), aims principally for the impact returns. While the focus of the former is on participating in potential gains, the focus of the latter is on only subsidizing efforts that end up achieving the impact sought.

Recoverable grants are especially suited for enterprises that are still in a proof-of-concept stage, where even risk capital is scarce, and when the potential social or environmental benefits may be so great that they merit high levels of subsidies before there is market traction. These circumstances are often of very high risk, where booking a loan would likely result in a loss, yet where there is a possibility that the enterprise may become financially successful. In such a circumstance, a recoverable grant can be superior to a structure along the lines of debt or equity because of the lower cost of structuring, evaluating, and monitoring the investment. They are



used, for example, to fund feasibility studies and to cover predevelopment costs before seeking other long-term funding sources. In some cases, impact enterprises may easily access non-reimbursable donations purely based on the social or environmental benefits they offer, but they may prefer a recoverable grant structure if they want to build a track record for attracting investment capital and want to signal to other investors that their models may become commercially viable.

A recoverable grant is generally structured as a convertible note that has no expiration and lacks liquidation payback rights. The investor is repaid if and when a predetermined milestone is achieved, such as reaching a certain level of revenue or closing a subsequent financing round. A recoverable grant with a call option type of feature places the obligation to repay on the enterprise until a certain milestone is hit—hence the moniker “don’t pay for success.” Once the enterprise reaches the threshold of impact, it can request the grant provider to eliminate the obligation to pay.

Philanthropic capital can also be used as a grant incentive to make the enterprise more attractive to investors, such as via a bonus to the investor upon achievement of desired milestones by the impact enterprise.<sup>7</sup> In another model, an outcome payer, such as a public funder or philanthropic organization, acts as a key customer to the enterprise, paying premiums for its social contribution. With the premium, the impact of the enterprise is directly tied to its levels of profitability, automatically raising its attractiveness for investors.

The case studies on alternative structures in grants are listed in the table below.

CASE STUDIES ON ALTERNATIVE STRUCTURES IN GRANTS

Multilateral Investment Fund	Reimbursable Innovation Grants
Multilateral Investment Fund	“Don’t Pay for Success”
Rockefeller Foundation	Social Success Note
Roots of Impact	Social Impact Incentives (SIINC)

7 These impact incentives are similar to pay-for-success models. However, this report does not include a discussion of social impact bonds or similar pay-for-success models.

## 5. Alternatives to the Closed-End Fund

The traditional capital aggregation model of the closed-end fund has limitations when applied to impact enterprises, in particular due to the longer time it can take to generate returns and due to the lower likelihood that one enterprise can “return the fund” as expected in venture capital funds. The requirement for the fund manager to return capital to investors within a few years can create a mismatch for an otherwise financially viable impact enterprise that requires longer to reach maturity than the fund can allow. Two mainstays of traditional finance have emerged as potentially attractive alternatives for capital aggregation for impact enterprise financing: holding company structures and open-ended funds.

Venture capital and private equity funds are traditionally structured as closed-end funds. Such funds are characterized by a specified fund lifetime, with limits on its fundraising and investment periods. The investment period typically lasts 4-6 years, while the overall term of the fund is usually 10-12 years, during which exits are sought for the portfolio companies.

This fund structure presents several challenges when it comes to investments in impact enterprises. The exit-oriented strategy of closed-end funds discourages a longer growth timeline for the enterprise and favors high-risk, high-reward enterprises. As it can take 7-10 years for an impact enterprise to reach break-even, pressure to exit within the life of the fund may compromise either the enterprise’s mission or its natural growth trajectory.

In contrast, open-ended funds are akin to permanent capital vehicles without a fixed life. In open-ended funds there is no time limit for fundraising or for when the fund must be liquidated.<sup>8</sup> Without such limits, open-ended funds are able to keep enterprises in their portfolios for longer periods—avoiding either an unrealistic growth trajectory or sale to a misaligned acquirer. An open-ended fund may maintain enterprises in its portfolio indefinitely, value is returned to investors in the form of dividends and appreciation. For the investee, this means less pressure to adapt the enterprise to the requirements of the investor.

### CLOSED-END FUNDS, HOLDING COMPANIES, AND OPEN-ENDED FUNDS: SAMPLE STRUCTURE AND TERMS

	Sample closed-end fund	Sample holding company	Sample open-ended fund
<b>Fundraising</b>	Limited fundraising period	Ongoing	Ongoing, including “evergreen” reinvestment
<b>Liquidation/exit</b>	Assets liquidated by a finite term; portfolio companies exited within term	Open-ended exit strategy and potential to sell/float entire HoldCo	No finite term for liquidation; open-ended exit strategy
<b>Governance</b>	Investment committee and Limited Partner Advisory Committee	Board of directors	Investment committee, Limited Partner Advisory Committee, advisory board
<b>Fee and compensation structure</b>	Management fee and carried interest after target	Budget-based fees and carried interest after target	Management fee and percentage of cash distributions
<b>Size/scale</b>	Single target fund size	Open to several rounds at different valuations	Open to several rounds at different valuations

<sup>8</sup> Open-ended funds are often called “evergreen funds,” though some practitioners distinguish between the two and favor the use of “evergreen” for open-ended funds where the proceeds are re-invested into the fund, rather than distributed. This report follows the convention of referring to the funds as open-ended, except for the NESST Loan Fund, which is self-styled as an evergreen fund.

Investors in an open-ended fund, rather than pledging capital for future draw-downs, provide the capital upon entering the fund, and have flexibility on when to exit (subject to conditions).

The holding company structure, or HoldCo, provides another alternative to closed-end funds. A HoldCo is not a fund, but a parent company that owns a portfolio of subsidiaries, often within the same geography or sector to promote synergies among the enterprises. The structure as a company, rather than a fund, means that capital invested in a HoldCo is more liquid than that in a closed-end fund—to the extent that there is a market for investors to

enter and exit the HoldCo. Like open-ended funds, HoldCos do not have a forced exit, providing similarly favorable conditions for impact enterprises. HoldCos can be particularly attractive where the underlying enterprises have a clear but longer path to cash flow due to a longer business cycle, where they operated in illiquid markets, or where there are strong synergies across the portfolio (for example, with a portfolio of agricultural investments across the supply chain in Central America).

The case studies on alternatives to the closed-end fund are listed in the table below.

CASE STUDIES ON ALTERNATIVES TO THE CLOSED-END FUND

Encourage Capital	HoldCo Structure
Aqua-Spark	Open-Ended Fund
Triodos Bank	Open-Ended Fund
NESsT	Evergreen Social Enterprise Loan Fund
Enclude	Offshore Investment Vehicle



## 6. Next Steps and Way Forward

The emergence of alternative financing structures is a positive development for increasing the availability of adequate and aligned capital for impact enterprises in Latin America.

Given the compelling reasons for innovation in alternative financing structures and the existence of viable models currently being used, action can be taken to ensure continued innovation and broader adoption. Below are the areas that participants in working sessions highlighted as fruitful avenues for further exploration. You are encouraged to submit your own comments and recommendations to [info@transformfinance.org](mailto:info@transformfinance.org).

### FOSTER THE SYSTEMATIZATION OF STRUCTURES

The emerging alternative structures are tailored variations of the models presented above. The bespoke nature of the structures constitutes their strength, as they can adapt to specific contexts. However, it also constitutes a drawback in terms of the ease of building and marketing such structures. This creates higher transaction costs and makes alternative structures more time consuming to execute. This issue is even more salient among institutional investors who seek structures that fit within predefined investment policies. Even an emerging consensus around terminology would help the use of specific structures, as it would put investors and entrepreneurs in a better position to compare the various alternatives.

While too much standardization could defeat the purpose of having a menu of customizable structures, a framework approach could help. Some practitioners have suggested the creation of a flow chart or decision tree that directs the user toward the most appropriate structure by stage of enterprise, path to profitability, sector, seasonal consistency of revenues, and other characteristics.

The Impact Terms Project ([www.impactterms.org](http://www.impactterms.org)) has made significant strides toward documenting and explaining existing structures. To support progress in this field, investors can contribute by sharing their experiences and investment documentation. Practitioners could further contribute to the systematization of alternative structures by sharing their rationale for electing a particular model.

It is likely that over time, from the existing experimentation, a few main structures will emerge that are broadly suitable for a variety of contexts, leading to higher familiarity, as discussed below, and reduced transaction and structuring costs.

### SOCIALIZE THE SUCCESS STORIES

Entrepreneurs and investors are less familiar with success stories in alternative financing than with the more broadly celebrated traditional exits. This perpetuates the narrative, in particular among entrepreneurs, that equates success with a traditional venture capital round of financing, regardless of whether that is what is most suited for the enterprise.

The field would benefit from broader dissemination of success stories, including the terms that were used for each case, and why it was both beneficial for the investors and the enterprises. Such sharing can also help to identify innovations to improve fund economics, systematize or standardize processes and procedures, and strengthen the capacity of fund managers, all while educating entrepreneurs and investors on the benefits of implementing these structures.

### INCREASE FAMILIARITY AMONG ENTREPRENEURS

Many entrepreneurs are not familiar with alternative financing structures, even where they would benefit from them. In many instances, venture capital models are the default for impact entrepreneurs seeking risk capital due to this lack of familiarity. Accelerators and advisors rarely feature or highlight alternative financing options in their work with early-stage and growth-stage impact enterprises.

This shortcoming can be addressed through targeted communication about alternative financing structures and through strengthening education programs available to entrepreneurs. A potential avenue is the development of curriculum modules focusing on alternative structures for accelerators.

### INCREASE FAMILIARITY AND COMFORT AMONG LIMITED PARTNERS AND FUND MANAGERS

Fund managers willing to adopt alternative deal structures across a fund, and even use alternatives to

the closed-end fund structure, report concerns that using nonstandard structures will make the fundraising process harder. This is attributed in part to investors being less familiar with and less eager to engage with the alternatives.

Educating investors and lenders, as well as fund accelerators and other intermediaries on the opportunity for investing in funds that pursue alternatives can meaningfully address the fund managers' concern.

## FINANCE AND FUND MORE FUNDS WITH A DEFINED MANDATE AROUND ALTERNATIVE STRUCTURES

There is a growing community of limited partners that have experimented with alternative financing structures through direct deals who may be particularly interested in managers that apply them throughout a fund.

Limited partners could commit to anchoring new funds willing to implement alternative structures. This in turn would make more prospective fund managers willing to focus on the most adequate structure for a particular reality, rather than the perceived ease of raising a more conventional fund.

Such a comfort-generating soft commitment to invest could take place either as an individual limited partner initiative, or as a concerted effort of a consortium of limited partners investing directly into funds or through a fund of funds or holding company of funds.

## CONTRIBUTE TO THE CONCEPTUALIZATION OF A SEPARATE ASSET CLASS

What is now considered traditional venture capital and private equity was deemed esoteric until just a few decades ago. It was only when these investments consolidated into an asset class that a dramatically higher amount of capital started to flow to them. At that point, institutional investors were able to fit private equity deals into their investment policy statements.

It is easy to envision a similar path for alternative deal structures, were they to be systematized into a set of opportunities with similar characteristics. This would enable investors to compare alternatively structured deals among themselves, rather than pooled with traditional venture capital terms. The benefits of this possibility should be kept present as the field seeks to systematize terms.

The creation of an asset class around alternative structures would further contribute to the point highlighted just above, as more investors would be able to fit their mandate to invest

in alternative structures into a separate allocation bucket corresponding to the alternative structures asset class.

## SUPPORT POLICIES AND REGULATORY INITIATIVES THAT ENCOURAGE ALTERNATIVE STRUCTURES

While policy makers have an important role in stimulating and directing investment, rarely have they proposed laws, regulations, and programs that support alternative financing structures for impact enterprises. Policy efforts have been fundamental in directing funding for social and environmental outcomes, for example, by providing tax incentives to charitable contributions from corporations and individuals. They have also benefitted capital flows to early-stage businesses to stimulate entrepreneurial growth. For example, several governments have instilled tax incentives for early-stage investments. However, these tax advantages are based on a traditional venture capital model aimed at profit maximization and do not lend themselves to alternative financing structures – even where such structures further the purpose of the underlying policy.

The venture capital industry has also successfully influenced regulators. To illustrate this, in the United States, exemptions were granted to investment advisor registration at the federal level for funds pursuing a “venture capital strategy.” But investors, particularly asset owners, can do more to influence policy makers or to propose policies for innovations in financing structures. Along with other field builders, investors could also play a role in supporting the work of lawyers and academics exploring bottlenecks and areas of policy improvement.

An enormous opportunity exists for government agencies and policy makers to join investors and financial intermediaries to explore, incentivize, test, and even fund alternative financing structures for impact enterprises. For example, public finance institutions such as development banks can do more to de-risk these financing innovations, thus gradually crowding-in private investment. Increased coordination across jurisdictions could lower existing barriers and signal the support of governments and regulatory agencies for such alternatives.

## COORDINATE EFFORTS

Several efforts have emerged to advance innovation and adoption of alternative structures. Even though different approaches are a welcome contribution and can themselves spur innovation in methodologies, coordination among the various players exploring alternative structures can increase efficiency and avoid duplication of efforts.

# **CASE STUDIES:**

Alternative Structures in Debt and Equity



## ENCLUDE: VARIABLE PAYMENT OBLIGATION

### UNDERLYING CHALLENGE:

Debt financing is unavailable to small enterprises lacking collateral

### TARGET GROUP:

Small enterprises, especially women-owned, seeking US\$25,000 to US\$50,000

### PROPOSED SOLUTION:

Cashflow-based repayments as a percentage of revenue; de-risk enterprises for lender

### IMPACT OPPORTUNITY:

Enable women-owned small enterprises to grow

Small enterprises in Central America continue to face difficulties accessing capital, including through bank lending. This is particularly so for enterprises that do not have collateral and whose revenues tend to fluctuate throughout the year. Banks, despite their willingness in principle to lend to such enterprises, are traditionally not able to do so under their lending requirements.

To provide this type of financing, banks need an effective de-risking mechanism as well as a different underwriting methodology. Enclude's Variable Payment Obligation (VPO) benefits both the enterprises and the banks eager to grow their business into loans previously deemed too small and too risky. The model is based on an innovative underwriting methodology that centers on cashflow,

rather than traditional collateral. Through variable repayment terms tied to revenue generation of the enterprise, the VPO provides repayment flexibility to the enterprise and aligns the incentives of both parties.

### INVESTMENT STRUCTURE

The VPO loans are issued by the bank directly and are booked on its balance sheet. Repayments are made directly to the bank, which bears the credit risk, based on a percentage of actual revenue, rather than following a fixed schedule. The loan has a final maturity date; however, it is set such that the repayment would be expected to complete well ahead of the final maturity. The maturity date is necessary due to regulatory and technical



In order for this model to work we have to engage with local banks: increasingly, they understand why they need these alternatives as they seek new business opportunities. Success requires keeping the needs of the enterprise front and center while engaging with the banks to design solutions that meet their needs and address their operating constraints—from risk mitigation via participation of investors, to product innovation and business support services for the target enterprises, to more realistic and flexible underwriting standards that focus on cashflow, to training of loan officers and more. Importantly, this model is replicable across markets as a blueprint that will require adaptation for jurisdiction-specific requirements.”

*Laurie Spengler, President & CEO, Enclude*



requirements for the bank and the likelihood that this familiar term would help initial adoption by both lenders and borrowers. The VPO seeks to combine flexibility with a degree of standardization of terms that allows it to be offered by commercial banks.

Enclude's partners in the VPO offer business development services alongside and prior to the loan to accelerate the borrower's growth, strengthen loan monitoring, reduce the risk of default, and increase program impact and sustainability.

## SPOTLIGHT TRANSACTION: Loans for Women-Owned Companies

Enclude is piloting the VPO among women-owned or women-led companies in Nicaragua. The typical recipient has annual sales of US\$100,000 –US\$250,000. Tailored to the local market environment, the pilot loans have a term of five years (expected not to be reached), and an annual interest rate of 18 percent, which is favorable under local lending conditions. The loans range in size from US\$25,000 to US\$50,000. There is no prepayment penalty; the faster the company grows, the faster the repayment. The loans are suited for enterprise growth as they primarily fund inventory purchases and machinery and material acquisition.

To further reduce the risk to participating local banks and to accelerate scaling up, the VPO program will create a special-purpose vehicle through which other investors can participate in the loans. This mechanism creates a path to facilitate the flow of additional capital to small enterprises throughout the region.

The local bank-led syndication model can enable co-lending by partner banks and investors.

Subject to legal considerations, the model should be replicable in other geographies.

The loan structure does not require a pledge of assets for loans under US\$30,000, which extends credit to previously unbankable entrepreneurs. By offering repayment as a variable percentage of revenue, the VPO reduces the financial strain on the enterprise.

Local bank partners have an opportunity to integrate a new profitable financial product into their offering, which allows them to capture new markets and customer segments. They also benefit from access to methodologies, tool concepts, and lending best practices small and medium enterprises via consultants who support implementation of the program.

### Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>Loans with variable repayment based on actual revenue</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>Loans are booked by a local bank on its balance sheet</li> <li>No asset pledge for loans under US\$30,000</li> <li>Loan underwriting methodology focusing on cash flow as well as borrower willingness and capacity to pay, over collateral</li> <li>No pre-payment penalty</li> <li>Currently offered at 18% interest, favorable per local conditions</li> <li>Loan size: US\$25,000 – US\$50,000</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>Underwriting methodology that does not focus on collateral enables loans to flow to smaller, especially women-led enterprises</li> <li>The structure allows banks to offer previously unavailable loans</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>Loans are combined with business development services to prepare borrowers for capital infusion, accelerate borrower growth, augment loan monitoring, reduce risk of default.</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>Suitable for local banks willing to lend to smaller enterprises using alternatives to traditional collateral</li> <li>Suitable for previously unbankable enterprises with adequate cashflow</li> </ul>

## VILLAGE CAPITAL: REVENUE- BASED LOAN

### UNDERLYING CHALLENGE:

Founders seek mission-aligned growth and do not wish to dilute equity

### TARGET GROUP:

Early- to growth-stage companies with path to profitability but less than venture capital-style growth

### PROPOSED SOLUTION:

Revenue-based loans with honeymoon and equity conversion option

### IMPACT OPPORTUNITY:

Enable mission-aligned growth without dilution

Village Capital Fund has invested in sectors like health, financial services, education, energy and environment, and civic engagement. It has used alternative deal structures in five companies so far, particularly as revenue-based loans, for both early-stage and growth-stage companies.

## SPOTLIGHT TRANSACTION: Agriculture technology company investment

The fund invested via a revenue-based loan in a software- and hardware-based impact enterprise focused on helping farmers control pests and reduce pesticide use. At the time of the investment, the enterprise had US\$27,000 and a clear path to profitability, with growth forecasted at 320 percent for the year after investment. A licensing business model provided opportunities for growth and a strategic acquisition. However, the likely scale was not sufficient to attract traditional venture capital, and the founders were interested in non-dilutive capital amid raising equity from agriculture-focused strategic investors.

## INVESTMENT STRUCTURE

The revenue-based loan was selected because of a clear path to profitability through tech licensing, the founders' interest in non-dilutive funding, and the comfort on the part of the investor with revenue forecasts and ability to sustain the repayment. The loan provided for a repayment of 5 percent of revenue until the repayment of three times the original amount. The initial payment was triggered by reaching gross revenue of US\$50,000, or 12 months from the investment date.

The deal included optional equity conversion at a 10 percent discount of the outstanding principal amount plus accrued interest at 6 percent, exercisable upon a round of financing greater than US\$500,000, with future participation rights.

The fund specified use of proceeds and included triggers around mission parameters, with reporting requirements.

The fund targeted tripling its return over five years. The company grew annual revenues from US\$27,000 thousand at investment to US\$439,000 at repayment, and was on track to hit three times the return on investment (ROI) over 3.5 years.



These structures can require more active management than an equity investment due to the nature of quarterly payments and constant communication with the company about how their sales are going, what cash commitments they are anticipating, if any timeline has changed on receivables, and so on. But the activities around helping a company in which we have an equity investment prepare for exit and positioning them to engage with potential acquirers takes just as much effort—and may be over a much longer time frame, with a lot less certainty in terms of eventual outcome.”

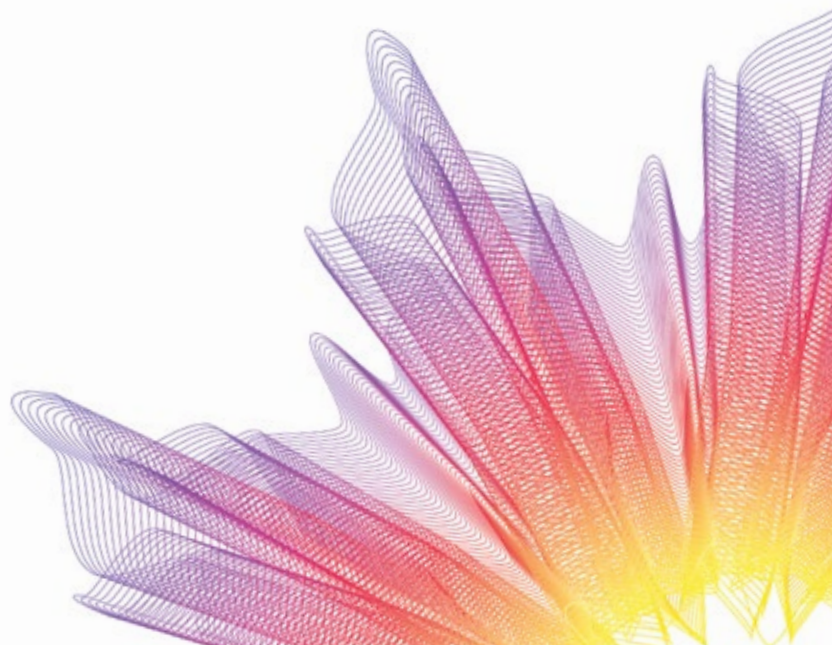
*Victoria Fram, Managing Director, Vilcap Investments*

The company subsequently raised US\$2.5 million in Series A equity at US\$15 million pre-money valuation. It benefited from the founder-friendly structure combining variable payments and a grace period.

The company’s Series A round triggered early repayment, which yielded a 2.1x gross return in under two years, per previously agreed-upon prepayment schedule (a 30 percent discount to target total repayment).

### Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>Revenue-based loans convertible to equity upon reaching milestones</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>Repayments based on a fixed percentage of revenue</li> <li>Flexible schedules with initial grace periods and a honeymoon until a revenue target is met</li> <li>Capped return (~3.0x)</li> <li>Convertibility is tied future financing round</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>Provision of capital for financially viable, growing impact enterprises with an exit path without diluting the founder</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>Less dilution for founders as compared to traditional equity</li> <li>Includes triggers around fulfilment of mission parameters</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>Post-revenue, early-growth impact enterprises with a clear path to profitability</li> <li>Founders looking to take on subsequent equity without wanting to dilute</li> </ul>



## LA BASE: FLEXIBLE DEBT FINANCING FOR WORKER- RECOVERED COMPANIES

In late 2001 the economy of Argentina collapsed, leaving thousands of workers unemployed as managers declared bankruptcy and abandoned their factories. Many of the displaced workers around the country reclaimed the factories cooperatively as Worker-Recovered Companies (WRCs). Financing for WRCs was hard to come by, as banks failed to lend and microcredit initiatives ignored this movement. La Base Argentina, part of The Working World International, aimed to fill this capital gap via tailor-made “mesocredit.” La Base lends exclusively to democratic, worker-owned businesses. With this model, La Base has provided financing for over 1,000 projects in 12 years, with a historical repayment rate of 98 percent.

### UNDERLYING CHALLENGE:

Lack of financing options for worker-owned enterprises; aspiration to lend without over-indebting

### TARGET GROUP:

Worker-recovered factories post-economic crisis

### PROPOSED SOLUTION:

Repayment out of free cash from specific financed project, flexible terms, no collateral

### IMPACT OPPORTUNITY:

Provision of capital for worker-owners in economic crisis

## INVESTMENT STRUCTURE

La Base loans must be approved by a majority of the recipient group. The loans do not provide cash directly to the entity; rather, the infusion payments are made directly by La Base to the supplier. Collateral is not required; in lieu of collateral, La Base reduces loan risk by requiring the provision of key information for the loan project design, through business support services, and through strong oversight rights.

Loans are only repaid from the income generated by the project to which the loan attaches, ensuring that the loan does not over-indebt or decapitalize the recipient. The interest rate is set to protect the sustainability of the La Base loan fund without unduly burdening free cash for the recipient. Loan features, such as size and repayment schedule, are flexible and tailored to match the unique characteristics of each recipient.

## SPOTLIGHT TRANSACTION: Esperanza del Plata Cooperative

The Esperanza del Plata Cooperative makes bags and coils with customized printing services. The business became a WRC in 2008 as the workers received legal permission to put the factory back into production after the previous owners had shut it down. The cooperative is not considered creditworthy by banks and does not qualify for microcredit programs.

La Base became its sole source of outside capital with a loan in September 2015 to finance the purchase of new machinery and provide lines of credit for the purchase of increasing volumes of raw material.

The loan terms require the reporting of biweekly income statements, monthly costs, and quarterly performance reports, and La Base can have an agent present at the monthly cooperative assembly. The entire loan cycle includes technical assistance for the introduction of good business practices.

Repayment is structured according to the rate of return to the cooperative specifically from the loan. The loan portion allocated to the machine featured a five-month semi-grace period of 50 percent reduction on repayments, to allow for the machine setup and implementation, as well as to account for sales seasonality. After the initial period, repayments increase every six months to match inflation. The repayment schedule is over 22 months, with an early repayment option in case of increases in revenue. The working capital portion of the loan is repaid immediately upon the receipt of customer payment for each financed order.

As of July 2017, the cooperative has repaid, according to schedule, 92 percent of the loan and has recorded an increase in the cooperative's assets and productivity. It has reported an increase in income of 88 percent from August 2015 to May 2017.

### Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>• Project-specific, cashflow debt financing</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>• Loan disbursements issue directly to suppliers, rather than to borrowers</li> <li>• Repayments out of free cash generated by the project itself</li> <li>• No collateral is required</li> <li>• Repayment schedule tied to cash generating ability of the project. Working capital loans are repaid directly from sales receipts</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>• Provision of capital for unbankable worker cooperatives with safeguards against over-indebtedness</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>• Lender relies on key information and strong oversight rights instead of collateral to derisk the loan</li> <li>• Majority of recipient's assembly must approve the loan</li> <li>• Technical assistance provided throughout the loan cycle</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Unbanked enterprises that cannot issue equity and require access to working capital</li> <li>• While the model is designed for democratically controlled entities, it is suitable for other enterprises seeking to avoid over-indebtedness while fulfilling working capital needs</li> </ul>



## ADOBE CAPITAL: REVENUE-BASED MEZZANINE DEBT

### UNDERLYING CHALLENGE:

Limited financing options for enterprises without a clear exit strategy

### TARGET GROUP:

Post-revenue, early-growth impact enterprises in Mexico with a clear path to profitability

### PROPOSED SOLUTION:

Revenue-based loans with flexible schedules, convertible into equity at a capped multiple

### IMPACT OPPORTUNITY:

Provision of capital for financially viable, growing impact enterprises

Adobe Social Mezzanine Fund I (ASMF I) was launched by Adobe Capital in 2012, with a focus on quasi-debt instruments, especially Mexican peso-denominated mezzanine debt with revenue-based repayment structures.<sup>9</sup> This US\$20 million fund invested in seven small and medium-sized impact businesses in Mexico in the healthcare, education, low-income housing, and alternative energy sectors. ASMF I targets a five-year repayment for the loans, with a 24 percent gross internal rate of return (IRR) in U.S. dollars. The fund's first exit recently provided a 22 percent IRR and a 1.5 multiple of the investment.

### INVESTMENT STRUCTURE

The ASMF I standard investment is structured as a revenue-based loan with flexible schedules and a grace period, including a broad prepayment option without penalty. While revenue-based, the loans may have a minimum monthly payment, with payments above the minimum reducing the principal. The loan has an equity conversion option at a predefined multiple, with a capped return of approximately 2.5x. As the principal is repaid, the convertible amount also decreases, ensuring that more equity remains with the founders as they repay the note.

This debt structure is founder-friendly because of its alignment of incentives between the fund and the

### Benefits for Fund and Enterprise

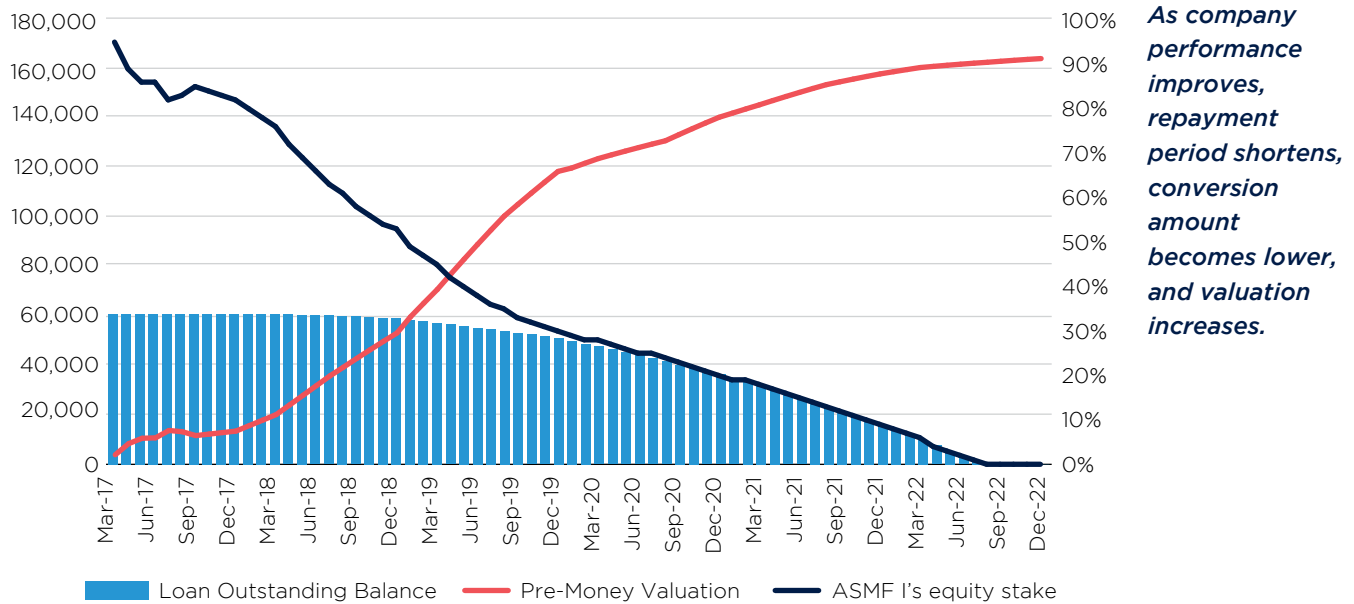
From the Fund's perspective, the IRR of the investment increases if the enterprise exceeds expectations, given that the enterprise has the option to prepay the loan at a fixed multiple. Even if an enterprise underperforms, it can produce a 20 percent IRR in US dollars.

From the enterprise's perspective, if it experiences a period of low revenue, it is not saddled with a large loan payment due to the variability feature.

In case of a future write-off, the Fund would still realize some returns from the enterprise's payments to date, which provides some downside protection. In case of bankruptcy, the outstanding loan amount would remain due, with recovery depending on its seniority among the creditors.

enterprise: as the enterprise's financial performance improves, the repayment period is shortened and the company's valuation is increased, with the fund's equity stake in the enterprise decreasing. The progressive exit means that there is less potential dilution for the founders.

<sup>9</sup> While these alternative structures are being used across the fund, more traditional equity investments are also possible.



### Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>Revenue-based loans convertible to equity</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>Repayments based on a fixed percentage of revenue</li> <li>Flexible schedules with initial grace periods</li> <li>Convertible into equity at pre-defined multiple with a capped return (~2.5x); convertible stake decreases with loan repayment</li> <li>Applied across a fund portfolio with target returns of 24 percent gross IRR</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>Provision of capital for financially viable, growing impact enterprises without a clear exit path</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>Less dilution for founders as compared to traditional equity</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>Post-revenue, early-growth impact enterprises with a clear path to profitability</li> <li>Founders looking to build long-term lifestyle businesses</li> <li>Clear path to liquidity in a market with few acquirers</li> <li>early growth stage social enterprises, particularly in healthcare, education, housing, and alternative energy</li> </ul>

## SPOTLIGHT TRANSACTION: NatGas—ASMF I's First Exit

ASMF I executed its first exit in May 2017 from an investment in NatGas. NatGas converts vehicles to bi-fuel gasoline/natural gas engines and operates compressed natural gas fueling stations in Mexico. Most of its customers are taxi and bus drivers from a lower economic bracket and with unstable incomes. NatGas offers a financing program for engine conversion, helping drivers to cut down on the substantial upfront investment.

NatGas was deemed too small for traditional equity investors and did not have the asset-backed guarantees required by banks. In 2014 NatGas received from ASMF I an MXN\$18 million investment, structured as a mix of revenue-based loan and equity. The company became profitable in 2014 and revenues grew through 2016. ASMF I exited NatGas in 2017 after another fund invested in the company and a group of shareholders bought its equity portion.

### NatGas Transaction - Summary of Indicative Terms and Conditions

Type of security	<ul style="list-style-type: none"> <li>Senior participating convertible loans plus preferred shares in the company</li> </ul>
Investment tranches	<ul style="list-style-type: none"> <li>Two tranches, the first totaling MXN\$17 million upon closing and the second totaling MXN\$23.5 million, 12 months after closing and upon successful achievement of certain milestones.</li> </ul>
Convertible loan features	<ul style="list-style-type: none"> <li>12-month grace period.</li> <li>Monthly repayments equal to 4 percent of the company's total revenues thereafter.</li> <li>Annualized interest rate of 20 percent. Any monthly revenue-based payment above the minimum amount due is deducted from the corresponding convertible loan balance.</li> <li>Outstanding balance may be repaid in full without penalty, although the total amount repaid shall not be less than twice the original amount.</li> <li>If the company fails to reach 70 percent of the prior calendar year's earnings before interest, taxes, depreciation, and amortization (EBITDA) as approved by the board in the corresponding budget, the outstanding balance can be converted into preferred shares.</li> </ul>
Preferred shares	<ul style="list-style-type: none"> <li>The First Tranche Preferred Shares shall be equal to 7.7 percent of the post-investment, fully diluted capitalization of the company. The Second Tranche Preferred Shares shall be equal to 9.1 percent of the post-investment, fully diluted capitalization of the company.</li> </ul>

## ELEOS FOUNDATION: DEMAND DIVIDEND

### UNDERLYING CHALLENGE:

Straight debt financing incompatible with seasonality of revenue in agricultural businesses

### TARGET GROUP:

Positive cash flow trajectory, growth-stage impact enterprise in agriculture

### PROPOSED SOLUTION:

Cashflow-based loans with long grace period, a capped multiple, and a conversion option

### IMPACT OPPORTUNITY:

Provision of capital to grow a viable impact enterprise seeking to increase income for poor farmers

The Eleos Foundation led a round of funding for Maya Mountain Cacao (MMC, now Uncommon Cocoa) with a demand dividend – a structure pioneered by John Kohler of Santa Clara University as a flexible way for impact enterprises to repay a loan based on variable cash flow. Eleos was looking for a reliable, reasonable return that was not contingent on a liquidity event, that accounted for the seasonality of the business, and that was not overly burdensome on MMC.

MMC sought to build a profitable, scalable business in Belize to increase incomes and lift thousands of cacao farming families out of extreme poverty by linking smallholder farmers to the specialty cacao industry in the United States. As cacao is a seasonal crop and the company's revenue is contingent on harvest, despite a positive cash flow the company was exploring growth financing opportunities other than straight debt.

## INVESTMENT STRUCTURE

The \$200,000 financing round was structured as a cashflow-based loan with a seven-year payback period. After an initial two-year grace period, repayment would come from 50 percent of MMC's free cash, until reaching twice the original amount invested. The investment targeted an IRR in the high teens with the seven-year payback.

For downside protection, a default would happen if the company fell short of 60 percent financial performance on a mutually agreed-upon business plan, or if after nine years of payments the investment

### Structuring Challenges: Transaction Costs

The structuring of the deal required considerable legal work, particularly to guarantee that the tax authority would consider the dividends as debt. While the analysis was provided pro bono, otherwise legal costs would have been prohibitive. This challenge is addressed by growing familiarity with this type of structure and the availability of replicable models.

While the lack of familiarity with the instrument could have been a concern for future investors, in this instance it did not prove to be the case and the roll-up into the equity round was fairly seamless, facilitated by having aligned investors negotiating on both sides.

had not resulted in at least a 7 percent annual interest rate equivalent for the investor.

In terms of upside, a conversion option was included to allow for participation in case the company was able to raise equity subsequently. In fact, four years after the initial investment, the demand dividend was rolled into a round of equity funding that injected additional capital into the company. While this constitutes a "round trip" for the demand dividend, it converted into an illiquid equity instrument, and did not constitute a full exit.

The variable payment obligation structure provided flexibility in executing payments to investors, especially given the seasonality of cacao production. MMC benefited from the two-year grace period, during which time it could use the investment to speed up cash flows. Because MMC used the proceeds to create capacity, rather than to meet product demand, it was not able to create early free cash flows.

### Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>• Demand dividend</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>• Cashflow-based loan</li> <li>• Two-year grace period</li> <li>• 50 percent of free cash goes to repayment until 2x original amount is reached</li> <li>• Repayments out of free cash generated by the project itself</li> <li>• Seven year target payback period</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>• Provision of capital for unbankable worker cooperatives with safeguards against over-indebtedness</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>• Conversion option in case of subsequent financing round</li> <li>• Default triggered if enterprise does not reach pre-set levels of growth</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Growth-stage impact enterprises, particularly in agriculture, with a positive cashflow trajectory</li> <li>• Enterprises without a clear exit path and with variable revenues throughout the year</li> </ul>





## INVERSOR: COMBINED REDEEMABLE EQUITY AND VARIABLE DEBT

### UNDERLYING CHALLENGE:

Need for significant capital to address both growth and working capital needs

### TARGET GROUP:

Impact enterprises with positive EBITDA, no clear exit, but potential strategic acquirer

### PROPOSED SOLUTION:

Combination of redeemable equity and cash flow-based loan

### IMPACT OPPORTUNITY:

Capitalization of a viable sustainable construction business

Inversor is a 10-year, closed-end private equity fund based in Colombia, with both domestic and international limited partners. It has invested approximately US\$8 million in the growth, expansion, and consolidation of small and medium impact enterprises in the country. Inversor acquires minority or controlling stakes in such companies or invests via subordinated debt with an optional conversion. The investments are structured according to the specific business models, growth plans, and cashflows of each company.

Borrowing from the variety of tools at its disposal, Inversor was able to combine both a structured equity and a variable debt instrument into the same investment.

## SPOTLIGHT TRANSACTION: Sustainable Construction Co.

Inversor realized a US\$1.3 million mixed-instrument investment in a sustainable construction company, with a redeemable equity portion geared toward strengthening the commercial capacity of the company and new product research and development, and a variable debt portion for working capital and construction materials.



## INVESTMENT STRUCTURE

### Redeemable equity terms:

- 30 percent minority stake, to be repurchased by the company over three years at a pre-established valuation based on an EBITDA multiple.
- The company set aside cash to repurchase the shares progressively over the three years.
- An option to sell to a strategic buyer was included in case the company was not able to repurchase the shares on schedule.
- Expected return to Inversor: 2.0x-2.2x.

### Variable debt terms:

The debt portion was structured with an amortization of principal and interest according to the financial performance of the company and its EBITDA targets. Inversor established a minimum target EBITDA for each year of the credit term. If that target EBITDA was met, the interest rate on the debt would be decreased. If the target EBITDA was exceeded, the company could use the cash surplus to make prepayments on the loan. The prepayments also had established targets; if they were met, the interest rate would be further reduced.

- Six-month grace period;
- Option to prepay in case excess cash was available, and option to convert the remaining principal to equity at a pre-established rate;
- Expected return to Inversor: 1.5x-1.8x.

### Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>• Combined Redeemable Equity and Variable Debt</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>• Combination of minority or controlling redeemable equity stake with subordinated debt with an optional conversion</li> <li>• Equity redemption structured over three years based on pre-established EBITDA multiple, with an expected return of 2.0x-2.2x</li> <li>• Principal and interest payment on debt portion based on EBITDA target, with an expected return of 1.5x-1.8x</li> <li>• Six month grace period on debt portion</li> <li>• Prepayment option based on free cash available</li> <li>• Option to convert the remaining principal to equity at a pre-established rate</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>• Provision of capital for growth stage enterprises without equity dilution</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>• Investment structure is tailored to the specific business models, growth plans, and cashflows of each company</li> <li>• The interest rate on the debt decreases if target EBITDA is reached</li> <li>• If target EBITDA is exceeded, debt can be prepaid from excess free cash, with further reduction of the interest rate</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Growth-stage impact enterprises with positive EBITDA, no clear exit, but potential for acquisition</li> </ul>

## ACUMEN: SELF-LIQUIDATING EQUITY FOR INVESTING IN COOPERATIVES

### UNDERLYING CHALLENGE:

Cooperative entities need equity-like capital but cannot take on equity investments

### TARGET GROUP:

Agribusiness cooperatives with value-adding opportunities

### PROPOSED SOLUTION:

Creation of a third jointly owned entity, with investor equity transferring to the cooperative over time, preserving its ownership

### IMPACT OPPORTUNITY:

Capitalization of a viable agribusiness cooperative that could not access traditional equity capital

Acumen has invested more than US\$100 million in over 100 companies globally to transform the lives of the poor in underserved markets. Acumen Latin America, started in 2014, has made investments totaling US\$4.5 million in six agribusiness companies in Colombia and Peru.

Given the challenging markets and sectors in which it invests, Acumen uses innovative equity structures with self-liquidating mechanisms to mitigate the exit risks from illiquidity in emerging markets and the limited equity investor appetite for businesses

operating in post-conflict rural Colombia, where Acumen's has a strong focus.

The use of innovative structures also allows Acumen to partner with entities, such as cooperatives, that would not be able to receive equity investments. One such instance is a self-liquidating structure that allowed Acumen to partner with a cooperative to support the creation of a wet mill, aimed at increasing income for hundreds of small coffee producers in Colombia.

### SPOTLIGHT TRANSACTION: Coffee growers' cooperative association, redeemable equity plus debt

In 2016 Acumen invested in Gigante Central Wet Mill (GCW), a central wet mill and drying facility to be developed by the Asociación de Cafeteros el Desarrollo (ACD), a coffee grower's association based in Gigante, Huila. The wet mill model centralizes and standardizes a process currently done manually by smallholder farmers; this increases the amount of high-quality coffee that can be sold at a premium. Nespresso and SKN Caribecafe (SKN), which had been operating in the region, were facing challenges to source premium quality coffee, so the wet mill was an interesting value proposition for them. SKN partnered with GCW to guarantee the purchase of all output.

### INVESTMENT STRUCTURE

Because Acumen could not invest equity directly in ACD, GCW was constituted as a third entity, co-owned by Acumen and ACD. Acumen then invested in GCW through a combination of equity and debt, totaling US\$460,000. The equity portion was calculated as the maximum that would still qualify as a minority stake in the company. The debt component was estimated based on the remaining capital needs to operate a financially sustainable structure.

The debt is repaid on a fixed schedule, with a two-year grace period. Acumen has a pledge on machinery and a mortgage on the real estate property of the GCW.

The equity stake of Acumen in GCW will be redeemed using excess cash flow. GCW places all free cash in a reserve account. A percentage of that reserve is allocated to repurchasing Acumen's stake until it has been fully redeemed and Acumen has received a pre-agreed return.

The timelines of the debt and equity exit are designed to be fairly aligned, although the equity redemption will vary, by its terms, and may take place before or after repayment of the debt.

Rationales of the structure for the investor:

- It solves the exit challenge. In this case, the possibility of a liquidity event coming from the sale of the company is limited and there is a preference for ownership remaining with the ACD.
- When structuring the transaction Acumen acknowledged that this investment would have outsized social impact but did not expect it would have the potential for outsized financial return. Therefore, priority was given to a structure that provides downside protection.
- In turn, sharing the ownership of the GCW with an association will help Acumen to better understand the challenges involved in the operation of a business unit in partnership with an association.

Rationales of the structure for the enterprise:

- Acumen is providing not only capital but also support to strengthen ACD's capacity to run a business professionally. By the time Acumen's share in the company has been fully repurchased, the association is expected to be empowered and capable of managing the central mill with a strategic view and appropriate governance practices.
- The exit mechanism would allow ACD members to fully own the GCW operation when the operating

## Need and Potential for Replication

Central wet-milling and drying adds value in four main ways: (1) it improves operational efficiency, (2) it produces a large and stable volume of high-quality coffee that can be sold at a premium, (3) it provides new opportunities for smallholder farmers as entrepreneurs and managers, and (4) it reduces negative environmental impact and the costs of complying with regulations for farmers. There is an estimated market for approximately 1,000 central wet-mills across Colombia, where there are more than 220,000 coffee smallholder farmers who have fallen into poverty.

The GCW is an innovation that could have wide impact on the coffee sector and it has the potential to become the spearhead of a larger investment to replicate the centralized wet-milling business jointly with coffee farmer associations. The model could also transform the way coffee associations do business by transforming their operations into scalable business units.

know-how and governance structure are robust enough to guarantee a sustainable operation.

- The exit strategy is a means to empower smallholder farmers who would become pioneer businessmen with the competencies to manage an accountable business, which would boost the competitiveness of Colombia's coffee sector.

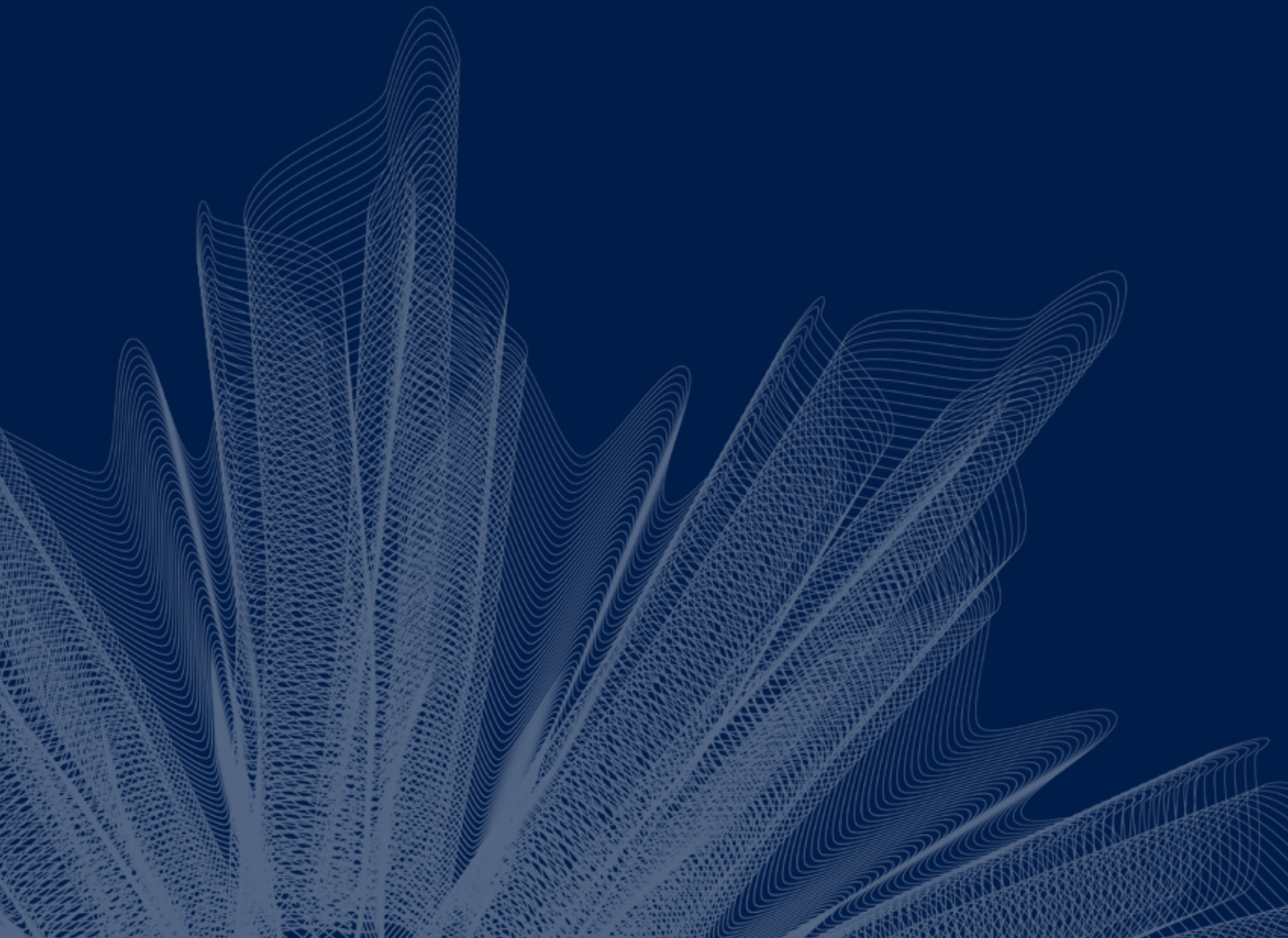
## Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>• Self-liquidating equity into a third entity</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>• A third entity is established by the funder and the cooperative</li> <li>• The cooperative maintains a controlling stake over the third entity</li> <li>• The funder provides equity capital up to the maximum for minority control and provides the remaining amount as debt</li> <li>• Debt financing is provided on a fixed schedule with a two year grace period; collateral is provided by the real estate of the third entity</li> <li>• Equity portion self-liquidates based on a percentage of excess cash flow of the third entity</li> <li>• Equity repurchase is aimed to achieve a pre-agreed multiple for the funder</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>• Provision of capital for growth without dilution and without prospects for exit; focus on building an asset for the target owner group</li> <li>• Creation of downside protection for high-impact financing with limited upside</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>• Provision of business services and capacity building along with the financing</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Impact enterprises that need equity-like capital but cannot issue equity, such as cooperatives</li> </ul>



# **CASE STUDIES:**

## Alternative Structures in Grants





# MULTILATERAL INVESTMENT FUND: REIMBURSABLE GRANTS

## UNDERLYING CHALLENGE:

Lack of traditional risk capital to finance early innovative interventions; limited availability of grant capital

## TARGET GROUP:

Proof-of-concept and early-stage impact enterprises in Latin America and the Caribbean

## PROPOSED SOLUTION:

Grants with potential for reimbursement via revenue-based repayment on predefined success terms and potential conversion to equity

## IMPACT OPPORTUNITY:

Seeding underfunded innovation that has potential to grow and have impact

The Multilateral Investment Fund, member of the Inter-American Development Bank Group, is developing several financing instruments to support innovative and market-driven business models that create social impact in Latin America and the Caribbean. These instruments are intended for companies at a proof-of-concept or early stages of development where risk financing is often very limited.

The reimbursable grant structure aims to provide startups with a risk-sharing mechanism that incentivizes experimentation with business models that have a compelling social or development impact. It targets companies that are beyond prototype and ready to launch a commercial pilot in Latin America and the Caribbean. The MIF's primary goal is to help bring to market disruptive technologies addressing social issues, while recovering its capital if they become commercially viable. The possibility of a financial upside is given through an equity conversion option that is only triggered in a predefined liquidity event.

## INVESTMENT STRUCTURE

- The enterprise receives successive partial disbursements of capital based on reaching implementation milestones. There is no automatic repayment obligation and no interest accrues on the disbursed amount.

## Potential to Spur Innovation

A reimbursable grant removes the risk to the entrepreneur by having no financial cost or interest rate unless the enterprise succeeds. As such, it has the potential to spur social innovation by removing downside risk for the entrepreneur and by providing the type of capital traditionally associated with proof-of-concept stage innovations, which is scarce in Latin America and the Caribbean.

- A level of Minimum Commercial Viability (MCV) is predefined, typically in terms of cumulative revenues. Once this level is reached, the enterprise is required to repay the funding. If the company does not reach MCV, there is no obligation to repay. The grant provider bears the risk of MCV not being reached.
- Once MCV is reached, repayments are based on a percentage of revenue and are scheduled with fixed semi-annual amounts with a grace period. Repayment obligations increase gradually with subsequent revenue milestones until 100 percent of the disbursed grant is recovered. The financing has no interest rate.

- There is potential upside for the investor with a liquidity event: a negotiated equity conversion right is triggered if the company goes public or is sold to a strategic buyer. The investor also has the right to participate in future financing rounds.
- These grants can include an incentive for early repayment or for achieving social impact (typically in the form of a payment discount) to better align interests.
- As a risk mitigation strategy, the MIF requires the company to secure “counterpart” funding (the risk sharing concept), and to actively seek “professional” investors who can finance and provide value-added advice during the ramp-up phase.

### Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>• Reimbursable grant</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>• Capital is disbursed in the form of a grant in successive partial disbursements based on reaching implementation milestones</li> <li>• No interest accrues on the disbursed amount</li> <li>• In lieu of automatic repayment, reimbursement of the grant happens via a revenue-based repayment based on predefined success terms semi-annually, with a grace period</li> <li>• The outstanding grant amount can be converted to equity upon a sale or initial public offering</li> <li>• Grant provider reserves the right to participate in subsequent financing rounds</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>• Provision of capital for high risk innovations to help bring to market disruptive technologies addressing social issues, with the possibility of recovery of capital and upside if the enterprise becomes commercially viable</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>• Terms can include an incentive for achieving social impact (typically in the form of a payment discount)</li> <li>• Grant provider may require counterpart funding from non-grant investors</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Proof-of-concept and early-stage innovations with upside potential in Latin America and the Caribbean</li> </ul>

## MULTILATERAL INVESTMENT FUND: “DON’T PAY FOR SUCCESS”

The Multilateral Investment Fund, member of the Inter-American Development Bank Group, is developing several financing instruments to support innovative and market-driven business models that create social impact in Latin America and the Caribbean. These instruments are intended for companies at a proof-of-concept or early stages of development where risk financing is often very limited. Among those, the MIF is piloting a “Don’t Pay for Success” recoverable grant structure, for firms or organizations that are providing investment advice and business acceleration support to early-stage and growth companies to align incentives to meet social targets.

### Reimbursable grants to intermediaries

A reimbursable grant can also be used to finance an intermediary organization providing investment advice and support to early-stage and growth companies. The grant can be linked to predefined impact targets for the intermediary and underlying enterprises.

### UNDERLYING CHALLENGE:

Lack of traditional risk capital to finance early innovative interventions; limited availability of grant capital

### TARGET GROUP:

Proof-of-concept and early-stage impact enterprises in Latin America and the Caribbean

### PROPOSED SOLUTION:

Grants with discounts based on achievement of impact targets

### IMPACT OPPORTUNITY:

Alignment of incentives to achieve impact targets

## INVESTMENT STRUCTURE

The MIF and partner organization arrive at predetermined impact targets. The MIF provides a grant to finance activities for up to three years. The successful achievement of the agreed targets by the partner organization trigger discounts that could reduce the repayment of the reimbursable grant to zero.

Repayment and discounts. This model proposes a grace period of three years (that is, a number of years to execute the project and achieve results) and a subsequent repayment period of three years. During the repayment period, an independent consultant/ auditor issues annual reports on the status of the agreed targets and determines whether the partner organization is eligible for a discount. The discount would be triggered if the partner achieves 80–100 percent of the agreed targets and would not increase if the partner achieves more than 100 percent of the targets. The maximum amount of the discount equals the full amount of the reimbursable grant. That is, if the intermediary delivers on all the targets agreed, the repayment would be equal to zero. The total discount will be evenly distributed during the repayment period (years 4, 5, and 6), and the achievement of each target will be tied to a fixed discount amount.

## Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>• “Don’t Pay for Success” grant for providers of investment advice and business acceleration support</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>• Grant provided to an intermediary working to consolidate and scale impact enterprises</li> <li>• If the agreed targets are achieved by the partner organization, a discount is triggered</li> <li>• Discounts can reduce the repayment of the reimbursable grant to zero, based on achievement above 80 percent of target</li> <li>• The grant has a term of up to three years</li> <li>• If intermediary delivers on all targets agreed, repayment equals zero</li> <li>• Grace period of three years</li> <li>• Subsequent repayment period of three years</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>• Provision of capital for consolidation and scale of impact enterprises with the possibility of recovery of capital if impact targets are not achieved</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>• Discount is evenly distributed during the three repayment years</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Intermediaries working to consolidate and scale impact enterprises to align incentives to meet impact targets</li> </ul>



# ROCKEFELLER FOUNDATION: SOCIAL SUCCESS NOTE

## UNDERLYING CHALLENGE:

Some viable impact enterprises offer below-market returns that fail to attract investors

## TARGET GROUP:

Impact enterprises with high measurable impact potential and return profiles marginally below investor expectations

### PROPOSED SOLUTION:

Additional payment provided to the investor in case certain impact targets are achieved, aligning investor interests and achievement of impact

## IMPACT OPPORTUNITY:

## Capitalization of high-impact enterprises based on achievement of outcomes

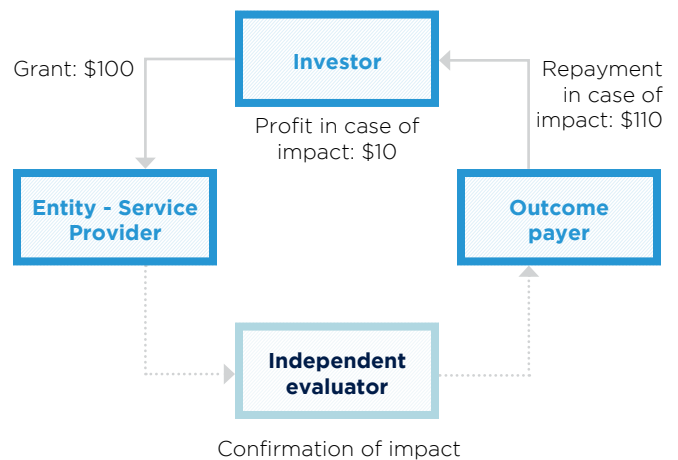
The Social Success Note (SSN), developed and piloted by the Rockefeller Foundation and Yunus Social Business, is designed to assist impact enterprises by crowding in commercial investment. The pay-for-success financing solution has application wherever there is the potential to provide an incentive for greater positive social and environmental impact through an outcome payment linked to investment.

## INVESTMENT STRUCTURE

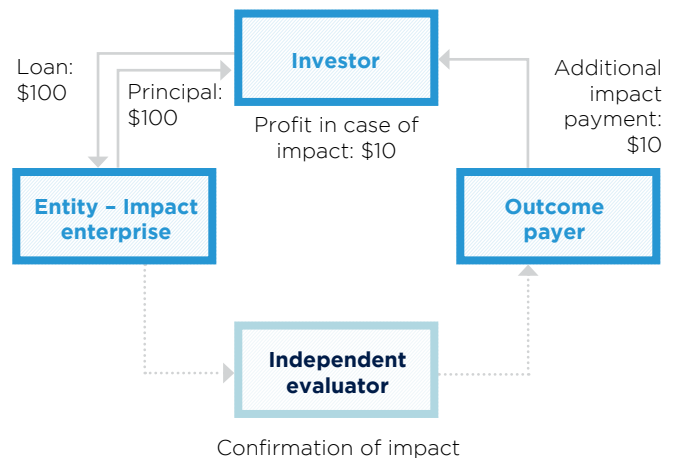
In the SSN structure, a private investor agrees to make capital available to an impact enterprise at a below-market rate. The investee is obligated to repay the investment; if it achieves a predetermined social outcome, a philanthropic outcome payer provides the investor an additional “impact payment” that aims to bring the investment to a market-rate return. The investor bears the risk of the impact not being achieved, which would lower the returns to the investor.

The SSN harnesses the power of pay-for-success contracts, and like similar models, it involves three parties: an impact enterprise, an investor, and an outcome payer.

## Social Impact Bond



## Social Success Note





The SSN aims to achieve two goals: attracting more private capital, and placing the risk of the impact not being achieved on the investor. Unlike other pay-for-success models, where the returns to the investor are linked only to the outcomes,<sup>10</sup> the impact risk is limited to the return portion that is provided by the philanthropic investor. The philanthropic provider stands to achieve the desired impact for a limited cost, and bears no cost if the impact is not achieved.

### Summary of Features

<b>The Instrument</b>	<ul style="list-style-type: none"> <li>• Top-up payment to third-party investors based on achievement of impact</li> </ul>
<b>Key Investment Terms</b>	<ul style="list-style-type: none"> <li>• A separate commercial investor provides capital at below-market terms to the impact enterprise</li> <li>• The provider of the social success note pays an additional impact payment to the investor if the enterprise achieves a pre-established impact</li> </ul>
<b>Benefits from the Innovation</b>	<ul style="list-style-type: none"> <li>• Alignment of investor interest with achievement of impact</li> <li>• Crowding in of capital that requires marginally higher returns</li> </ul>
<b>Key Additional Features</b>	<ul style="list-style-type: none"> <li>• The risk of lower returns from the enterprise not achieving its impact is borne by the investor</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Viable impact enterprises that fail to attract investors barring the potential for an additional return</li> </ul>

<sup>10</sup> Recent pay-for-success models can provide for partial returns based on partial achievement of the impact sought.

# ROOTS OF IMPACT: SOCIAL IMPACT INCENTIVES

## UNDERLYING CHALLENGE:

Viable impact enterprises that cannot monetize positive externalities struggle to find growth capital

## TARGET GROUP:

Impact enterprises with a proven model that need capital to scale

## PROPOSED SOLUTION:

Premium payment provided to the enterprise for the achievement of positive externality targets through growth; boost in profits attracts investors

## IMPACT OPPORTUNITY:

Capitalization of high-impact enterprises based on achievement of outcomes

The Social Impact Incentives structure (SIINC) aims to help high-impact enterprises attract investment to reach scale by improving profitability based on the achievement of impact.

## INVESTMENT STRUCTURE

As a technical matter, a SIINC is not an investment, but a purchase contract. An outcome payer, such as a foundation or a public entity, commits to purchase the positive outcomes created by the impact enterprise. These payments recognize the positive externalities of the impact enterprise and improve its financial position, thereby attracting investors.

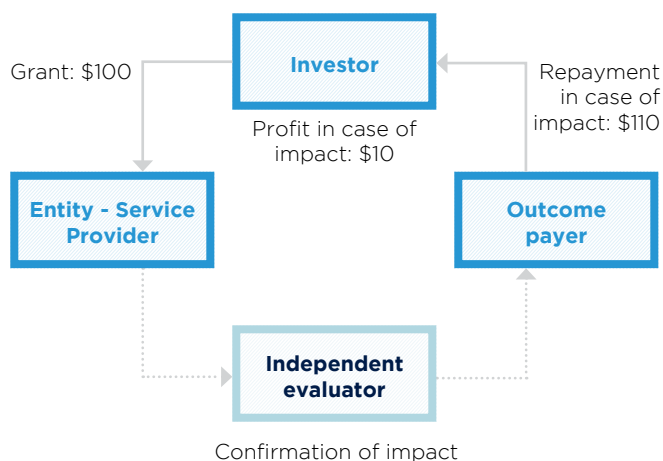
The structure is built on an assumption that the outcome payment will be temporary, as it will no longer be needed once the impact enterprise achieves scale (and economies of scale allow it to deliver the same impact at a lower cost). As such, it is conceived as a vehicle to carry impact enterprises faster to a level of scale that would make them intrinsically attractive to investors interested in both financial and impact returns. In an ideal SIINC structure, the impact enterprises should be able to achieve strong impacts and post solid financial results.

Technically, unlike in a pay-for-success or even Social Success Note, only two actors are required in a typical SIINC transaction: impact enterprises and public or philanthropic funders seeking to purchase the impact. The potential investor in the impact enterprise does not necessarily have a relationship with the outcome payer. However, the SIINC may provide an option for the outcome payer to withdraw if the impact enterprise does not secure the financing required to achieve scale.

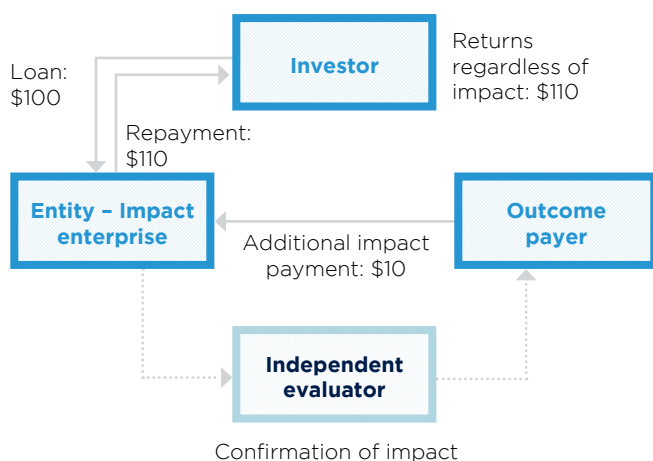
Roots of Impact has closed two contracts with impact enterprises, one in Mexico and another in Honduras.

## COMPARING SIB, SSN, AND SIINC STRUCTURES

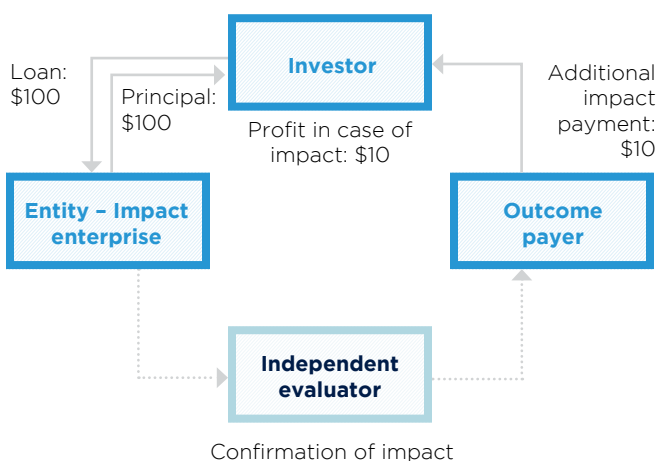
### Social Impact Bond



### Social Impact Incentive



### Social Success Note



## SPOTLIGHT TRANSACTION: Clínicas del Azúcar

Clínicas del Azúcar (CDA) operates a network of one-stop-shops in Mexico offering high-quality, cost-effective, and specialized healthcare services to treat and prevent diabetes. CDA's vision is to give every Mexican access to this service, regardless of socioeconomic background. So far, CDA has reached more than 50,000 patients from various income groups with nine clinics. The enterprise now targets a massive scaling to expand its services nationally.

The SIINC aims to reward and incentivize CDA to increase the penetration of diabetes services to the poorest while maintaining top quality of services by piloting new approaches to scale and serve this hard-to-access population group.

The SIINC mechanism is based on two metrics and will award payments on improving growth and success rates in the treatment of the poorest patients. In addition, impact is supposed to grow through the development of targeted prevention

### CDA SIINC Terms

- Maximum amount of performance based payments (SIINC): US\$275,000
- Period of ongoing SIINC performance-based payments: 2.5 years
- Preferred follow-on scenario: public contract
- Total amount of investment mobilized (equity): US\$1.5 million
- Investment round: Series B

# SPOTLIGHT TRANSACTION: Village Infrastructure Angels

Village Infrastructure Angels (VIA) provides solar home systems and solar-powered agro-processing mills run by women entrepreneurs in remote Honduran communities that lack access to electricity. Women in rural areas spend significant time processing the crops, a very labor-intensive activity, and solar-powered mills save substantial time on manual work and allow women to engage in more income-generating activities, resulting in higher family income.

VIA has traditionally provided simple household electrification; the SIINC aims to incentivize VIA to expand further into solar-powered mills. The outcome-based revenue will complement income from the villages, creating a solid business case for VIA to attract investors.

## VIA SIINC Terms

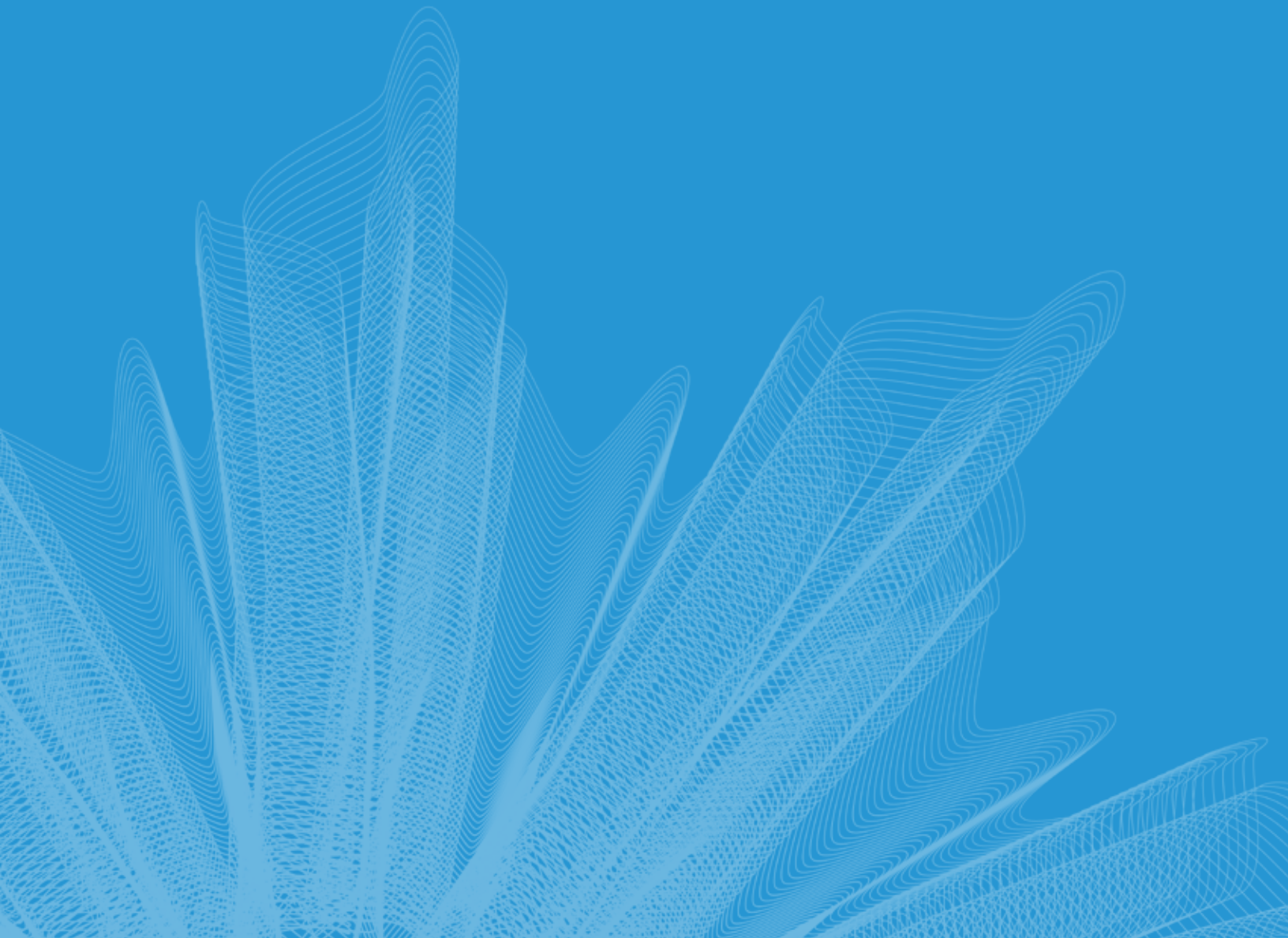
- Maximum amount of performance based payments (SIINC): US\$195,000
- Period of ongoing SIINC performance-based payments: 4 years
- Preferred follow-on scenario: self-sustainability via economies of scale
- Total amount of investment mobilized (debt): US\$318,000

## Summary of Features

The Instrument	<ul style="list-style-type: none"><li>• Top-up payment to enterprise based on achievement of impact</li></ul>
Key Investment Terms	<ul style="list-style-type: none"><li>• The investment is structured as a purchase contract for the positive externality created by the enterprise</li><li>• The additional revenue makes the enterprise more attractive to investors before it reaches the right scale</li></ul>
Benefits from the Innovation	<ul style="list-style-type: none"><li>• The top-up payment rewards the enterprise for reaching otherwise less profitable demographics</li><li>• The boost in profits enables the enterprise to attract investors until right-scale is achieved</li></ul>
Key Additional Features	<ul style="list-style-type: none"><li>• The risk of lower returns from the enterprise not achieving its impact is borne by the investor</li></ul>
Suitability	<ul style="list-style-type: none"><li>• Viable impact enterprises that fail to attract investors barring the potential for an additional return</li></ul>

# **CASE STUDIES:**

## Alternatives to the Closed-End Fund



## ENCOURAGE CAPITAL: PESCADOR HOLDINGS HOLDCO STRUCTURE

### UNDERLYING CHALLENGE:

Closed-end fund structure does not meet timeline of impact and fails to exploit synergies

### TARGET GROUP:

Growing enterprises in lower middle market private equity focused on a high-impact sector

### PROPOSED SOLUTION:

A holding company of entities within a supply chain matching financial and impact timelines and returns

### IMPACT OPPORTUNITY:

Ecosystemic solution aligning impact and returns; ecosystem restoration and better livelihoods

Pescador Holdings is an investment holding company making equity investments in lower middle market private equity sustainable seafood companies in Latin America.

The company aims to invest in ways that protect and restore fisheries. It identifies seafood companies and fisheries of sufficient scale to drive systemic improvements in fishery management and commercialization. It looks for opportunities to use market leverage to improve fisheries management and commercialization to create a vertically integrated, just, and transparent supply chain.

The commercial investments are bundled with investments in Fishery Improvement Projects (FIPs) to achieve a “biological IRR / J Curve” and are placed in a long-term holding company structure to realize synergies across companies and FIPs.

Returns are driven primarily by:

- Increased raw material volume availability and reliability linked to stock recovery
- Improvements in supply chain efficiency
- Access to higher-value markets
- Improved fisheries management and commercialization.

## INVESTMENT STRUCTURE

Pescador Holdings is structured as a holding company with a target size of US\$75 million and a gross IRR of 15–20 percent. It aims to build a portfolio of five to seven control and active minority investments ranging from US\$5 million to US\$20 million. The platform also allows for additional equity rounds, with a target US\$300–500 million deployed over the long term.

Returns are driven by the profitability of the underlying businesses and the select disposition of companies or assets.

Liquidity to investors comes from:

- Dividends at option of board, with the flexibility to hold and reinvest dividends;
- The listing or the disposition of the holding company;
- The select disposition of companies or assets; and
- Transfers of stakes internally or to new investors after seven years.



## Why a Holding Company?

1. **Time Horizon:** Align time horizon of vehicle to optimize investment returns with time horizons necessary to achieve stock recovery (“biological IRR”) and livelihood improvement goals.
2. **Portfolio Synergies:** Capture additional economic value for investors by driving operational synergies and collaboration between portfolio companies “from shore to shelf.”
3. **Investor-Manager Alignment:** Align interests of managers and investors by incentivizing long-term value creation and delivery of impact objectives.

Pescador Holdings is managed with a services agreement to Encourage Capital. Governance rests with a Board of Directors made of investors, Encourage Capital, and independent directors, with an Investment Committee of managers and a Sustainability Advisory Committee.

Fees are in the form of a management budget determined by board; compensation to the manager is set at 20 percent of profits after a 6 percent preferred return.

## Summary of Features

<b>The Structure</b>	<ul style="list-style-type: none"> <li>• Holding company with portfolio of control and active minority investments in lower middle market private equity</li> </ul>
<b>Key terms</b>	<ul style="list-style-type: none"> <li>• Structured as a HoldCo</li> <li>• Target size of US\$75 million</li> <li>• Target gross IRR of 15-20 percent</li> <li>• Five to seven investments with ticket sizes from \$5 million to \$20 million</li> <li>• Foreseeable additional equity rounds up to a target of US\$300-500 million</li> <li>• Liquidity from dividends at option of board, listing or the disposition of the holding company; select disposition of companies or assets; and/or transfers of stakes internally or to new investors after seven years</li> <li>• Management budget determined by board of directors; additional compensation of 20 percent of dividends and profits after 6 percent target</li> </ul>
<b>Benefits from the innovation</b>	<ul style="list-style-type: none"> <li>• By investing to hold a suite of inter-related companies in the fisheries business, this HoldCo structure can support the increase of raw material volume availability and reliability linked to stock recovery, an efficient, vertically-integrated supply chain, access to higher-value markets, and improved fisheries’ management and commercialization</li> </ul>
<b>Additional Features</b>	<ul style="list-style-type: none"> <li>• Board of Directors includes Sustainability Advisory Committee</li> <li>• Managed under a service agreement with Encourage Capital</li> </ul>

## AQUA-SPARK: OPEN-ENDED FUND

### UNDERLYING CHALLENGE:

Closed-end fund structure is a mismatch for risk/return profile and lacks flexibility to create long-term value where returns are harvested on a longer horizon

### TARGET GROUP:

Sustainable small and medium enterprises across the aquaculture value chain

### PROPOSED SOLUTION:

An open-ended fund with cash distributions and entry-exit opportunities harvesting long-term returns

### IMPACT OPPORTUNITY:

Scale companies committed to economic, environmental, and social sustainability to create ecologically viable sources of seafood products

Aqua-Spark is a global investment fund that invests in sustainable aquaculture businesses across the value chain of alternative feed solutions, farming, technology, disease treatments, and market access. It targets minority stakes of 20–49 percent in small and medium companies with the potential to pay out strong dividends five to seven years after the initial investment. The influential but minority stake approach is tied to an effort to diversify, from a risk perspective, across species and geographies, rather than taking control of companies. The fund seeks to create synergies within the portfolio, aiming to draw a line through all the companies and see how they can be connected and cross-supported.

While returns are focused on dividends, occasional exits are contemplated. For the majority of its investments, the fund aims to keep its ownership stake, as it generally considers exits detrimental both to the synergy thesis of the fund and to its potential for impact.

Ninety percent of capital is invested in companies that are ready to scale, and 10 percent is invested in riskier, earlier-stage investments.

### INVESTMENT STRUCTURE

Aqua-Spark is incorporated as a cooperative with excluded liability under Dutch law and is structured as an open-ended fund. The open-ended fund model

allows Aqua-Spark to invest for a longer time horizon, which addresses both the problem of innovative aquaculture companies taking longer to mature and the opportunity to harvest returns long after the end of a traditional closed-end fund. It has a separate management company with an operating company behind it.

The fund has a target ROI of 12 percent per year and a target fund size of €300–400 million in 10 years, with current assets under management of €49 million. Investments range from €250,000 to €5 million, and minimum entry into the fund is set at €100,000.

The annual management fee is 1 percent of capital invested or total net asset value of the fund, whichever is highest. As the management fee does not cover fund costs in the short term, the fund's managing partners invest €3.25 million over the first seven years to pay for all management costs above the 1 percent. After the first seven years, the fund fees should be sufficient to cover costs.

Returns to investors come in the form of cash distributions, 80 percent of which goes directly to investors. There is no target. The remaining 20 percent goes to Aqua-Spark B.V., an entity held by the Dutch Foundation of WorldFish, the founders, and the management team. Reinvestments of proceeds are not contemplated.



Ask first what you want to do, then find the right instrument. Then adjust the instrument to accommodate the needs of the investors. The structure is a means to an end, not the other way around.”

*Mike Velings, Founder and Managing Partner, Aqua-Spark*

Although the fund aims for steady dividends from its portfolio, it may exit from investments at the discretion of the Investment Committee.

Every six months, new investors can enter the fund at the prevailing valuation. The valuation is based on net asset value, and is performed every six months by the fund administrator and audited externally.

Investors will be able to exit the fund after 2019, with a five-year lock-up. With every fundraising round, a maximum of 50 percent of new funds raised will be used for redemptions of current investors at the prevailing valuation. The remainder of the new investment amounts will be used to grow the fund.

### Summary of Features

<b>The Structure</b>	<ul style="list-style-type: none"> <li>• Open-ended fund with a portfolio of minority investments</li> </ul>
<b>Key terms</b>	<ul style="list-style-type: none"> <li>• Structured as an open ended fund under Dutch law (cooperative fund structure)</li> <li>• Targets minority stakes in small and medium enterprises</li> <li>• Investments range from €250,000 to €5 million</li> <li>• 90 percent of capital invested in scaling companies, 10 percent in early-stage companies</li> <li>• Current fund size is €49 million</li> <li>• Target fund size is up to €300-400 million in ten years</li> <li>• Returns distributed through cash distributions based on revenues, with Aqua-Spark retaining a 20 percent performance fee</li> <li>• Fundraising every 6 months, with new investors entering at current valuation determined by third-party audit</li> <li>• 50 percent of new funds used for redemptions of investors at the current valuation</li> <li>• Management fee is 1 percent</li> <li>• Targeted ROI of 12 percent per year</li> </ul>
<b>Benefits from the innovation</b>	<ul style="list-style-type: none"> <li>• Structure aligns the timeline of the investments with the timeline of the synergies among portfolio companies, allowing for longer harvesting of value and consistency with the development of the aquaculture industry</li> </ul>
<b>Additional Features</b>	<ul style="list-style-type: none"> <li>• The fund's managing partners contribute €3.25 million over the first seven years to cover management costs above 1 percent management fee</li> <li>• 20 percent performance fee split between Aqua-Spark B.V., an entity held by the Dutch Foundation of WorldFish, founders, and management team</li> <li>• Reinvestments of proceeds are not contemplated</li> </ul>

## TRIODOS BANK: OPEN-ENDED FUND

### UNDERLYING CHALLENGE:

Capitalizing impact enterprises over a long term without forcing exits

### TARGET GROUP:

Mature sustainability companies in Europe

### PROPOSED SOLUTION:

An open-ended fund combining significant minority protection of its investments and control preservation for its investees

### IMPACT OPPORTUNITY:

Support the growth of mature companies that seek to remain independent and achieve impact via their products

Triodos Organic Growth Fund is a mission-aligned private equity open-ended Dutch fund focused on organic and sustainable consumer companies in Europe. It invests in profitable, mature companies at a growth stage; many have been privately held for 20–30 years and wish to remain independent while seeing a renewed need for growth/expansion capital or facing succession issues. Seventy percent of its portfolio is in sustainable food, soil fertility, and fair trade; the other 30 percent consists of textiles, fashion, personal care, and furniture. The investments are deployed in mature companies with a long-term investing strategy. For the benefit of the invested companies, exits are never forced.

### INVESTMENT STRUCTURE

The fund is structured as a semi-open Luxembourg-based SICAV (*Société d'Investissement À Capital Variable*) fund, that is, it is open-ended in principle, but can be temporarily closed if trading is not possible. The initial fund size at launch in January 2014 was €25 million, with a long-term target of €150–200 million. The investment size is typically €3–10 million, with a minimum of €1 million and €3–5 million as the sweet spot to allow for adequate portfolio diversification.

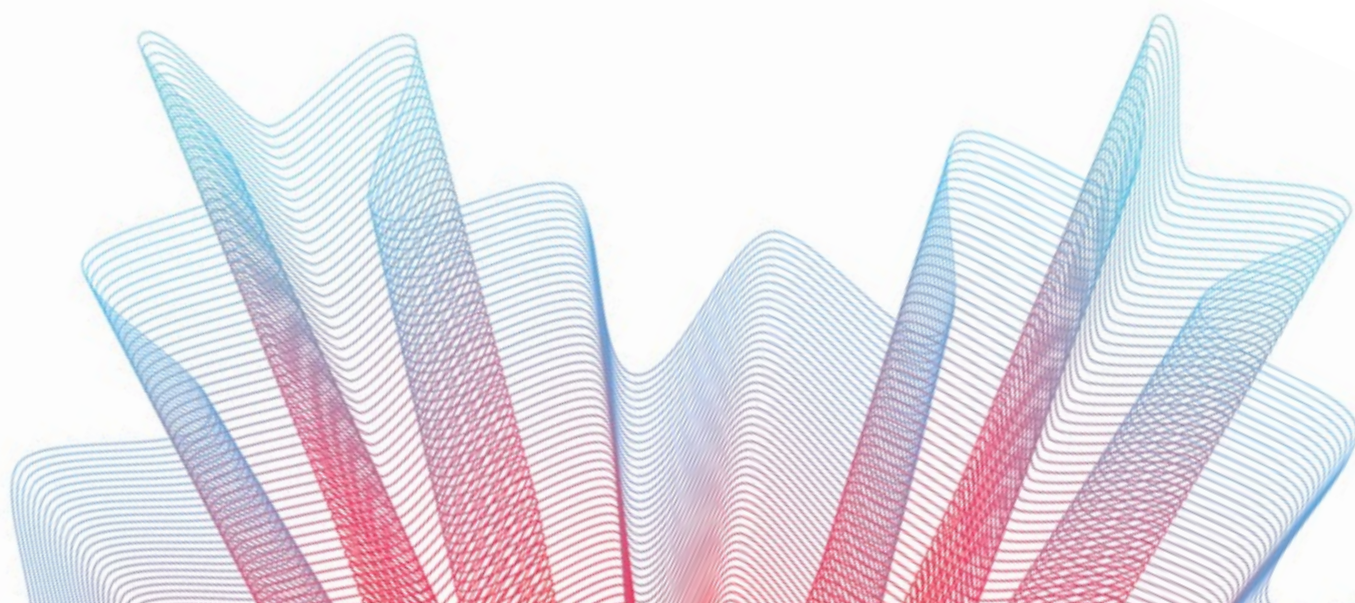
The fund takes significant minority or majority stakes and views itself as a long-term partner and seeks significant minority protection rights and a board seat. Transactions typically include pre-emptive rights to ensure that current shareholders retain control of any prospective changes in the shareholder structure. At the time of investment, the company and fund agree on an operational plan, with dividend policy determined on a case-by-case basis. Generally, the approach is to distribute back any cash that is not used to drive growth.

The fund generates dividend income from its portfolio and distributes all net income to investors, without reinvestment. Target long-term return for investors is 8 percent per year (over a 10-year period), with a portion expected to come in the form of dividends, and the balance driven by value appreciation. While investors in the fund are expected to have a long-term horizon, they can enter or exit the fund on a quarterly basis based on net asset value, provided sufficient liquidity is available. Net Asset Value is calculated quarterly, based on earnings multiples for the underlying portfolio, with multiples re-evaluated based on recent transaction data. During the initial three-year portfolio build-up period redemptions are also temporarily subject to a minimum fund size of €30 million.

To manage fund liquidity, if redemption requests exceed 10 percent of net assets of the fund, the fund has the right to defer. By way of historical comparison, two similarly structured Triodos Bank Funds, the Triodos Renewables Europe Fund (launched in 2006) and the Triodos Microfinance Fund (2009), have not had to defer redemptions.

### Summary of Features

<b>The Structure</b>	<ul style="list-style-type: none"> <li>• Open-ended fund</li> </ul>
<b>Key terms</b>	<ul style="list-style-type: none"> <li>• Semi-open Luxembourg-based SICAV (Société d'Investissement À Capital Variable)</li> <li>• Targets minority stakes in small and medium enterprises</li> <li>• Fund size at launch: €25 million</li> <li>• Long-term target fund size: €150–200 million</li> <li>• Typical investment size: €3–10 million (minimum €1 million)</li> <li>• Target returns: 8 percent per year</li> <li>• Investors can enter or exit the fund on a quarterly basis based on net asset value, provided sufficient liquidity is available</li> <li>• Net Asset Value is calculated quarterly, based on earnings multiples for the underlying portfolio</li> </ul>
<b>Benefits from the innovation</b>	<ul style="list-style-type: none"> <li>• Long-term capitalization of enterprises without forced exits</li> </ul>
<b>Additional Features</b>	<ul style="list-style-type: none"> <li>• Transactions typically include pre-emptive rights to ensure that current shareholders retain control</li> <li>• Fund and company agree on an operational plan, with dividend policy determined on a case-by-case basis</li> <li>• Cash not used to drive growth is generally distributed</li> <li>• During the initial three-year portfolio build-up period redemptions are also temporarily subject to a minimum fund size of €30 million</li> </ul>



## NESST: EVERGREEN SOCIAL ENTERPRISE LOAN FUND

### UNDERLYING CHALLENGE:

Lack of debt capital for impact enterprise growth in emerging markets despite ability to pay

### TARGET GROUP:

Impact enterprises creating quality jobs in Latin America without access to manageable debt for growth

### PROPOSED SOLUTION:

A pathway of capital from soft loans to convertible debt over the life of the enterprise

### IMPACT OPPORTUNITY:

Validation and scaling of enterprises seeking to create quality jobs in underserved communities in the region

NESST, a provider of funding and business assistance to over 200 impact enterprises in emerging market countries, training over 16,000 impact entrepreneurs, identified a gap in early-stage financing in Latin America, especially for debt capital under US\$500,000.

NESST's Latin America portfolio of entrepreneurs is currently not able to access growth capital, but can service debt. In fact, many entrepreneurs take loans before they enter NESST's programs, most with unfriendly terms, high interest rates, and complex covenants. Accessible debt capital is for short-term cash flow purposes as opposed to growth and investment. NESST estimates that 70 percent of its entrepreneurs can repay debt but cannot find suitable lenders or investors.

NESST operates three facilities: (1) a business assistance facility to increase the capacity of social enterprises; (2) a grants facility to provide social enterprises pre-investment capital; and (3) a loan facility to provide loans to enterprises that are cash flow positive and looking for growth capital. The loan facility has made loans on a pilot basis since 2008.

The NESST Social Enterprise Loan Fund will provide debt financing of US\$50,000 to US\$1 million—ordinarily unavailable to its investees—to validate and

scale enterprises creating quality jobs in the region, particularly in Brazil and Peru. The fund aims to deploy over US\$50 million over 10 years. NESST's loans are structured as:

- Soft loans or recoverable grants for promising enterprises high market potential, but no validated business model
- Traditional loans for companies with cash flow and validated model
- Convertible loans for high-growth companies, where NESST has the possibility to participate in the upside of successful companies.

The concept behind NESST's progressive lifetime line of loans is to provide long-term financing solutions that can support the entire funding cycle of an enterprise, avoiding the "valley of death" or "missing middle" scenarios. The soft loans create a pipeline of investable opportunities for NESST, which will be able to graduate its borrowers along its continuum. Approximately 10 percent of the fund will be disbursed as "soft loans" (recoverable grants) to meet the needs of seed stage impact enterprises. The remainder of the fund will be deployed as traditional loans or convertible loans to support more steady or fast-growth businesses. Interest rates on enterprise loans average 11 percent in U.S. dollars, which is below current business lending rates in the region.



## INVESTMENT STRUCTURE

The NESsT Social Enterprise Loan Fund will be a U.S. Limited Liability Company with NESsT (the manager) as its sole member. The fund will operate as an evergreen (that is, open-ended) nonprofit loan fund, to be created at the time of first closing.

The choice of nonprofit structure stems from the need to raise grants early on to sustain operations and build permanent capital to protect lenders, as well as to attract subordinated lenders who support the mission of channeling capital to underserved communities in Latin America.

To be catalytic and efficiently deploy capital toward social enterprises in Latin America, the fund requires a flexible structure knitting together philanthropic, private, and public capital. The fund's capital structure will be composed of three tranches of senior lenders, subordinated lenders, and grant providers. In addition, the fund will raise grants to sustain operations during the first three years.

The NESsT Board will elect the fund's Board of Directors, which will have responsibility over the separate entity managing the fund. The NESsT Board will also elect the fund's Investment Committee, which will consist of five members, a majority of whom will be independent from NESsT's management and governance.

### Summary of Features

<b>The Structure</b>	<ul style="list-style-type: none"> <li>• Open-ended nonprofit loan fund (structured as a U.S. limited liability company)</li> </ul>
<b>Key terms</b>	<ul style="list-style-type: none"> <li>• Target deployment of US\$50 million over ten years</li> <li>• The fund will accept several tiers of incoming capital to both deploy into impact enterprises as debt capital and to support its operations</li> <li>• About 10 percent of the fund will be disbursed as "soft loans" (recoverable grants) to meet the needs of seed stage, unproven social enterprises</li> <li>• Remainder of the fund will be deployed as traditional loans or convertible notes to support more steady or fast-growth businesses, with interest rates averaging 11 percent</li> <li>• Loans range from US\$50,000 to US\$1 million</li> </ul>
<b>Benefits from the innovation</b>	<ul style="list-style-type: none"> <li>• Open-ended structure allows the fund to grow as it proves its thesis. It also allows for better aligned capital for its investees</li> <li>• Soft loans create a pipeline for more traditional loans, which together support the entire life cycle of the enterprises</li> <li>• Convertible notes allow NESsT to participate in upside of fast-growth scalable businesses</li> </ul>
<b>Additional Features</b>	<ul style="list-style-type: none"> <li>• Loans come with business assistance to support the capacity of the enterprise</li> <li>• NESsT's board elects the fund's Board of Directors, which elects a five-member Investment Committee</li> <li>• The fund will raise grants to support operations in the first three years</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Impact enterprises suffering from the lack of manageable debt capital. The fund will address in particular impact enterprises that can graduate from soft loans to more commercial-type loan instruments</li> </ul>

## ENCLUDE: OFFSHORE INVESTMENT VEHICLE

### UNDERLYING CHALLENGE:

Need to create liquidity for fund investments into high-potential assets with longer paths to exit

### TARGET GROUP:

Mature portfolios of high-impact assets

### PROPOSED SOLUTION:

Holding company permanent vehicle providing opportunities for partial liquidity and for investment into more mature assets

### IMPACT OPPORTUNITY:

Provide a continuous source of capital to impact enterprises without forced exit risk

Investments that demand a longer period to generate results are not always suitable for a traditional closed-end fund structure, where the capital needs to be returned to the limited partners by a certain date. This challenge is familiar across private equity investment and is particularly familiar in impact investing where investors do not want to be forced to choose between diluting the impact potential of the underlying investment and the realization of financial return. Exploring a solution centered on returning capital to investors without disrupting capital deployed to the underlying investees, Enclude has structured a new investment vehicle that allows impact investment managers to increase liquidity for their limited partners, despite the potentially longer path to exit of the underlying high-potential assets. This vehicle also attempts to address other barriers currently keeping investors on the sidelines, from transaction costs to preference for more mature investment opportunities.

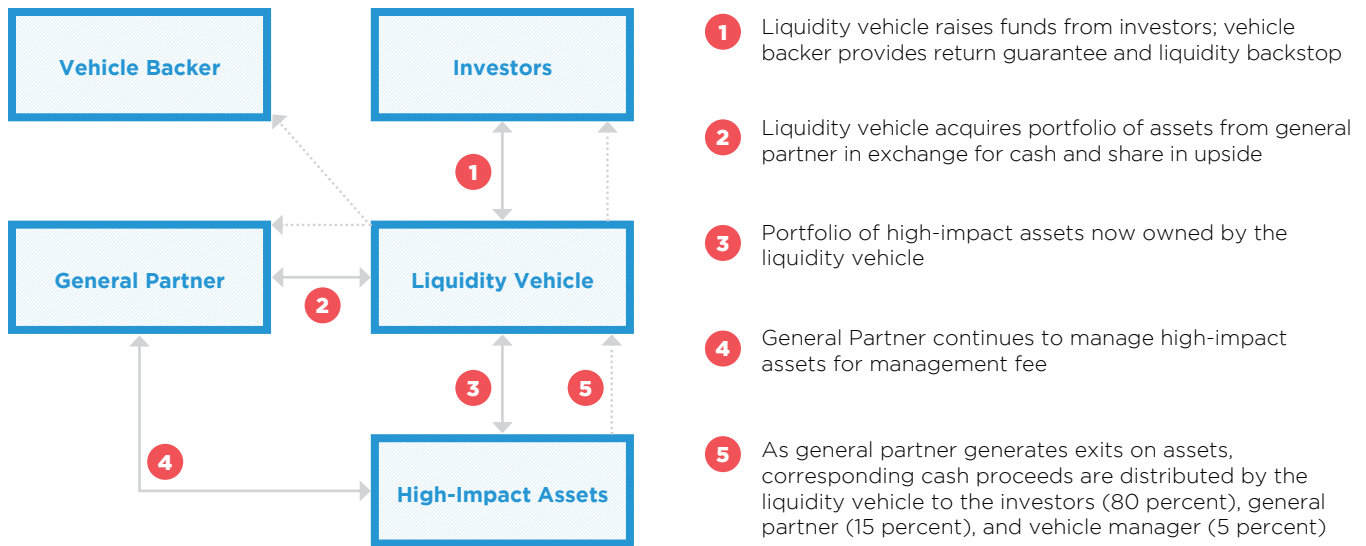
The Offshore Investment Vehicle (OIV) provides a liquidity solution on a portfolio basis to existing owners of assets, without jeopardizing the underlying assets' realization of financial and impact return. New investors into the OIV gain exposure to a pool of assets that represent more mature investment opportunities. Existing investors gain access to liquidity and help stimulate the beginning of a secondary market for impact investing. Working with the MacArthur Foundation, Enclude developed the OIV as a holding company to create a permanent vehicle to offer a reliable exit for more mature

portfolios and an accessible entry point for new investors. Anchor support of the OIV will come from several institutional investors who see the need to kick-start a secondary market.

The OIV aims to deploy capital with a multisector and multigeography strategy focused on emerging markets. Investors from different geographic regions and with different thematic priorities may invest in one or more of the portfolios acquired by the OIV. At launch, the initial size for the OIV is US\$20–30 million through the acquisition of an initial portfolio of investments, but it has natural capacity for growth by acquiring additional portfolios. Each acquired portfolio will represent a separate class of shares issued by the OIV.

### Target Investors

The OIV aims to attract (i) investors interested in impact investment but concerned about the timing and reliability of exits with closed-end funds; and (ii) investors already active in impact investing who are motivated to develop and participate in a viable secondary market solution. The new investors are sensitive to liquidity and seek to invest in underlying assets that can be identified up front. These investors are interested in investing in more mature entities in a manner that allows enterprises the additional time needed to generate an exit that is aligned with both its financial and impact objectives.



Source: Adapted from the GIIN HoldCo Working Group

The flexibility for the investors to enter and exit the OIV provides a continuous source of capital to the underlying enterprises that is not affected by the forced exit issues that arise within a traditional closed-end fund. By providing an alternative liquidity option, the OIV also increases the amount of aligned capital available to enterprises with longer gestation periods for development.

## INVESTMENT STRUCTURE

The OIV acquires a portfolio of assets from the original general partner in exchange for cash and a share of the upside. The original general partner continues to manage the assets and their exits, while the OIV manager screens opportunities, services the risk/liquidity mechanisms, and manages the reporting activities to the OIV's investors. The general partner has money at risk in two ways: (i) 20 percent of the initial sale proceeds are retained by the OIV and incorporated as part of the OIV reserve; and (ii) participation in the distribution of exit proceeds. An anchor investor identified as the "vehicle backer" provides an annual return guarantee of 1 percent to be paid retroactively at the time of exit or liquidation of an underlying asset. The target return of the OIV is 10+ percent (in U.S. dollars, net of fees).

The proceeds from exits on the underlying assets are distributed among the OIV investors (80 percent), the OIV manager (5 percent), and the general partner (15 percent). The proposed fees for the fund are 1-1.25 percent for the general partner and 0.75-1 percent for the OIV manager.

At vehicle launch, there will be a lock-up period of two years, during which a liquidity reserve for the fund will be built up by initial distributions and exit realizations of the portfolio on a priority basis. If the reserve is not fully funded, it will be supplemented by the vehicle backer of the OIV. After the lock-up period, the liquidity reserve will be replenished as needed from portfolio proceeds.

After the lock-up period, the OIV will open semi-annual liquidity windows allowing investors to exit the vehicle with up to 10 percent of their proportional share value of the net asset value (per availability of funds in the reserve). For this purpose, portfolio valuations will be performed twice a year.

## Summary of Features

<b>The Structure</b>	<ul style="list-style-type: none"> <li>• Holding Company that acquires stakes in existing investment portfolios</li> </ul>
<b>Key terms</b>	<ul style="list-style-type: none"> <li>• OIV raises funds from investors; vehicle backer provides a guarantee on returns and a liquidity backstop</li> <li>• OIV acquires a portfolio of assets from the original general partner in exchange for cash and a share of the upside</li> <li>• Original general partner continues to manage the assets and their exits</li> <li>• After a two-year lock-up period for the investors into the OIV, there will be semiannual windows for investor exit of their proportional share of up to 10 percent of net asset value</li> <li>• Target net return is above 10 percent in US dollars</li> <li>• Returns distributed to investors (80 percent), the OIV manager (5 percent) and the general partner (15 percent)</li> <li>• Fees: General partner (1-1.25 percent) and OIV manager (0.75-1 percent)</li> <li>• Initial size of vehicle targeted at US\$20-30 million, with expected growth</li> </ul>
<b>Benefits from the innovation</b>	<ul style="list-style-type: none"> <li>• Creation of a viable secondary market opportunity in impact investing without disrupting the capital available to impact enterprises</li> <li>• Flexibility of the open-ended structure allows a constant capital flow for the portfolio enterprises, reducing pressure for exit</li> <li>• Provides more mature investment opportunities to investors into the OIV</li> <li>• Provides a liquidity opportunity for general partners of high impact enterprises with a longer timeline to maturity</li> </ul>
<b>Additional Features</b>	<ul style="list-style-type: none"> <li>• Investors from different geographic regions and with different thematic priorities may invest in one or more of the portfolios acquired by the OIV</li> <li>• Anchor support of the OIV will come from several institutional investors</li> </ul>
<b>Suitability</b>	<ul style="list-style-type: none"> <li>• Impact investors seeking to invest in more mature impact enterprises and concerned about reliability and timing of traditional closed-end fund exits</li> <li>• General partners of funds holding impact enterprises seeking to get liquidity prior to the optimal time of exit from the investment</li> </ul>

## Background Resources

- Aner Ben Ami (Candide Group), “Square Peg, Round Hole” (2015)**  
 This brief provides an in-depth overview of the needs for alternatives to traditional financing mechanisms for impact enterprises.  
<http://transformfinance.org/blog/2015/7/26/square-peg-round-hole-innovating-finance-for-social-enterprises>
- Bruce Campbell (Blue Dot Advocates), Impact Terms Project**  
 The Impact Terms Project intends to share emerging practices across the impact investing field. The project provides standard terms and information about impact investing legal terms aiming to reduce legal uncertainty and burden. Examples are descriptions of innovative fund structures or methods for selection of an entity type for an impact enterprise.  
<http://www.impactterms.org>
- Deborah Burand, “Contracting for Impact: Embedding Social and Environmental Impact Goals into Loan Agreements,” 13 NYU J. L. & Bus. 776 (2017) (publication forthcoming).**
- Eelco Benink and Rob Winters (Dutch Good Growth Fund), “New Perspectives on Financing Small Cap SMEs in Emerging Markets. The case for mezzanine finance” (2016)**  
 A study on building small cap small and medium enterprise mezzanine finance as an asset class from the fund manager and investor sides.  
<http://english.dggf.nl/file/download/43861002>
- Delilah Rothenberg (Pegasus Capital Advisors), HoldCo Structures and Open-Ended Funds**  
 Via the GIIN HoldCo Working Group, a series of workshops have explored the applicability and current pain points for HoldCos and Open-Ended Funds.
- Josh Lerner, James Tighe, Steve Dew, Vladimir Bosiljevac, Ann Leamon, and Sandro Diez-Amigo (MIF), “Impact of Early Stage Equity Funds in Latin America” (2016)**  
 A report on the funds in which the MIF has invested. It looks at the direct impact of fund managers on portfolio companies and the impact of portfolio companies in their communities.  
<https://publications.iadb.org/bitstream/handle/11319/7892/Impact-of-Early-Stage-Equity-Funds-in-Latin-America.pdf?sequence=1&isAllowed=y>
- LAVCA, “Impact Investing Landscape in Latin America” (2016)**  
 A regional analysis of broad trends in fundraising, deals, and exits, along with a special focus on pipeline development, technical assistance, impact measurement, talent, and gender.  
<https://lavca.org/dealbook/impact-investing-landscape-latin-america/>
- Luni Libes (Fledge), Lunarmobiscuit.com Blog**  
 A series of posts on a variety of topics relating to impact entrepreneurship and impact investing, including revenue-based investments as an alternative to the venture capital model. Libes’s upcoming book, “The Next Step for Investors: Revenue Based Financing” will be available in late 2017.  
<http://lunarmobiscuit.com/category/revenue/>
- M. Bolis, C. West, E. Sahan, R. Nash and I. Irani (2017). Impact Investing: Who are we serving? A case of mismatch between supply and demand. Oxfam and Sumerian Partners.**  
 This report from Oxfam and Sumerian Partners questions some of the assumptions around impact investment and highlights the experience of enterprises contributing to poverty reduction so that they might be better served by the field. It argues that the sector risks being discredited due to rising, unrealistic expectations about financial returns.  
<https://www.oxfamamerica.org/static/media/files/dp-impact-investing-030417-en.pdf>



- **MIF, “Venture Capital: Driving Development in Latin America” (2013)**

A comprehensive study on venture capital as a form of economic development in Latin America, citing benefits such as social mobility, better environmental standards, tax revenues, employment, and growth.

<http://www19.iadb.org/intal/intalcdi/PE/2013/12976en.pdf>

- **Peter O’Driscoll (Orrick), “Rising to the Challenge of Growth Capital Equity Investment in the World’s Poorest Countries—A New Model” (2017)**

An analysis of deploying Growth Capital Equity in poor countries, and the author’s case for creating a private impact-driven fund to fill the gap.

<http://s3.amazonaws.com/cdn.orrick.com/files/Insights/ODriscoll-EMPEA-Bulletin-Spring-2017.pdf>

- **Tenke Zoltáni (UBS Impact Investing), “Holding Companies for Impact—Alternative structures to facilitate impact investing: a discussion on holding companies, traditional funds, and other options” (2016)**

This article, prepared with UBS and Skopos Impact Fund, looks at holding companies as a model for impact investing and how different fund structures interact with impact and profitability.





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