INNOVATIVE FINANCE TOOLKIT

Alternative structures for financing early-stage impact enterprises in Bangladesh

B-BRIDDHI
Scaling Impact Enterprises of Bangladesh

Innovative Finance Toolkit

Alternative structures for financing early-stage impact enterprises in Bangladesh

Created by

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Scaling Impact Enterprises of Bangladesh

A programme by

Roots of Impact

LightCastle Partners

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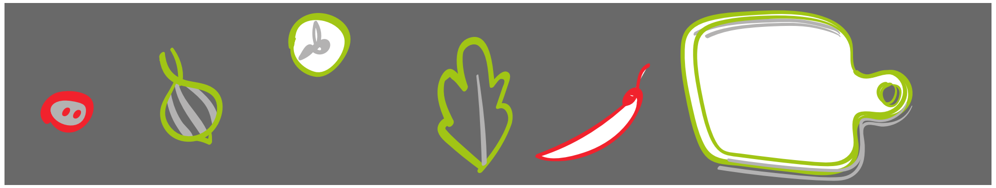
TABLE OF CONTENTS




IMPACT & BEYOND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PREFACE

The vast majority of early stage impact enterprises in Bangladesh are typically raising capital using standard equity or equity-like instruments that are designed to support fast-growing tech ventures. If a company is building a network of smallholder farmers across Bangladesh or a solution for disadvantaged youth helping them to get formal employment, why would they be funded using the same investment terms that were used to fund Facebook or Google? Impact enterprises focusing on the most disadvantaged people and marginalized markets are able to deliver social and environmental returns far beyond their own profits. Some of them have the potential to become impact unicorns – if they get appropriate support at the right time.

They might be able to generate considerable financial returns, but what makes them unique is their ability to find innovative ways of creating value for society. We need to redefine the terms of investments to better fit the unique attributes of impact enterprises — whether it be more patience, unconventional repayment options, or rewards for impact. In this toolkit, we want to highlight some of the alternative structures that can be used to support impact enterprises on their journey to create much-needed impact at scale

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INTRODUCTION

Access to finance is a key barrier for early stage impact enterprises to grow. But this is not only about the appropriate type of financing. There are more issues that entrepreneurs need to address in order to successfully approach investors and raise capital for scaling. The work of incubators, accelerators, and other service providers is of crucial importance for entrepreneurs on their journey towards investment and scale. The programme "B-BRIDDHI: Scaling Impact Enterprises of Bangladesh", is supporting the efforts of key actors in Bangladesh in order to contribute to an ecosystem where impact enterprises have better access to investment and investors can tap into a pipeline of investment-ready impact enterprises. More information about capacity building support of the programme can be found on the website B-BRIDDHI.

This toolkit is about innovative financing options tailored to the needs of impact enterprises. It is based on a multitude of inputs from experts, professionals, investors, entrepreneurs, and other stakeholders. The report encompasses the view of impact entrepreneurs, incubators and accelerators, field experts, and investors. The Innovative Finance Toolkit is meant to represent a starting point for further collaboration, discovery, and discussion on the topic. It is not intended to be a comprehensive nor a definitive guide to early-stage impact enterprise financing.

The goal is to provide inspiration about a spectrum of instruments that can increase the financing options available to investors and entrepreneurs in Bangladesh’s impact economy, delivering returns to investors and at the same time supporting the specific needs and goals of impact enterprises. Impact enterprises usually operate in a different ecosystem than traditional enterprises because they face more uncertainty due to possible instability, typically more challenging target client segments and infrastructure barriers that could lengthen the period of early stage.

Hence, it is important to select financing instruments that match an enterprise’s business model, needs, and the stage of development that the firm finds itself into, in order to help ensure the impact enterprise success and foster its development. A thorough analysis of the realities impact entrepreneurs face is needed to provide educated advice on the most appropriate form of capital to use and to fully capture the range of goals and interests of the entrepreneurs as well as the investors committed to support them.

During tough economic times and health crises like the Covid-19, companies can experience an increase in operational risk and financial duress, pushing them to obtain additional emergency short-term funding in order to cope with the problematic and uncertain situation. The pressure coming from the repayment of these short-term obligations often leads to the refocusing of the business towards more commercial, and traditional business areas and segments, thus resulting in a mission-drift of the impact enterprise. Therefore, it is of utmost importance to provide enterprises with powerful tools to best position their business to be flexible and resilient in such challenging times.

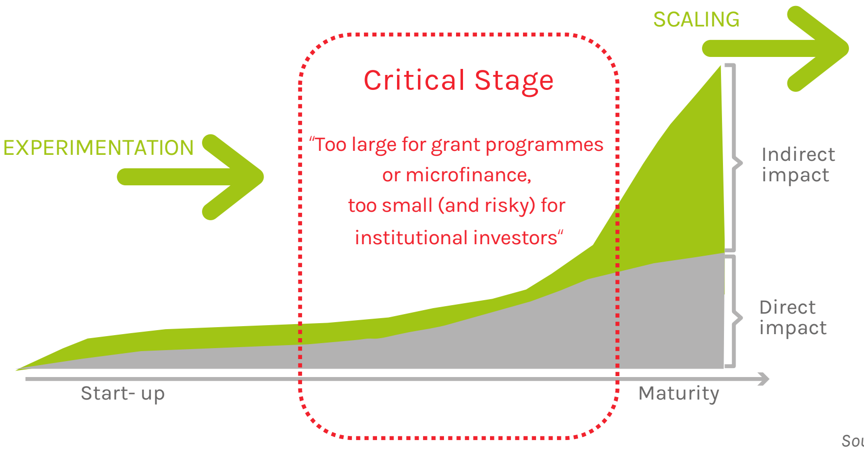
Impact entrepreneurs may not always look for a fast "exit"

In conventional finance, venture capital and private equity firms exert considerable influence and usually expect a financial return to come from a sale to third parties ("Exit"). This can be appealing for an entrepreneur who is looking for a strategic acquirer or access to public markets. In the case of impact enterprises, however, the private status of the firm and a careful selection of like-minded investors may help to preserve the original founder's goal and mission. Nevertheless, this might come with a price. Not following the rules of the mainstream capital market may limit the range of possibilities. Innovative financing instruments can help to overcoming this challenge.

A twofold financing challenge: innovation for impact and early stage

Access to appropriate financing is the key barrier for early stage enterprises, notably impact enterprises, to grow and flourish. Many local investors, including business angels and funds, are interested in the compelling idea of creating social value while at the same time doing business. Yet, they do not classify themselves as impact investors nor do they explicitly define impact criteria in their investment strategy. A lot of impact enterprises are scalable and profitable but their business, as per definition, is not traditional. Therefore, investors should not treat them as such and providing them with traditional financing instruments.

Since impact enterprises face considerable challenges in attracting capital that aligns with their needs and characteristics, they are often prevented from developing at their full potential. This is particularly the case for impact enterprises in the early and growth stages which are unlikely to meet the return requirements demanded by traditional private equity investors and venture capital funds. Another reason is that they cannot provide for the adequate risk mitigation in order to have access to traditional debt providers such as banks, and as a consequence, they do not survive past the seed stages of financing – a critical stage also called the "valley of death".



Source: Ashoka

Support for the supporters needed

On the side of the capital providers, intermediaries, and other service providers there is a lack of support around the structuring of innovative financing solutions. A strong differentiation between grant making on the one hand and investing on the other hand is another typical pitfall. The concept of Blended Finance is not well established, and its opportunities have yet remained unexplored. The aim of this toolkit is to provide impulses with selected examples for increasing the financing options available to investors and entrepreneurs.

HOW TO USE THIS TOOLKIT?

Some of the alternative financing structures are new to the market, and for this reason, they are not yet well understood by many practitioners, entailing less clarity about their tax, accounting, and legal merits as compared to those of traditional methods. This novelty could create complexity, or perceived complexity. But it's all worthwhile as it can lead to better financing options for the impact economy.

The toolkit shall be used as a source of inspiration for the further creative development of innovative financing instruments. For instance, it could be interesting to analyse gender-related issues and how they affect the development of impact enterprises and their capability to obtain funds. As a consequence, financing instruments could be designed which help women in funding their enterprises without additional barriers. Wider use and spectrum of available alternative financing tools does not only benefit impact enterprises but also SMEs in general: due to their size, they are intrinsically more vulnerable to variations in the credit market and therefore need a broader range of instruments.

The instruments highlighted in this toolkit are structured alongside five chapters: **Chapter 1** covers the financing instruments which resembles equity-type instruments and convertibles, **Chapter 2** elaborates catalytic impact-linked finance instruments which help to attract additional investment, **Chapter 3** features other impact-linked finance instruments, and **Chapter 4** focuses on other catalytic funding instruments which help to attract additional investment. Finally, **Chapter 5** covers results-based finance instruments for non-profit organisations. While non-profit organisations are generally not in scope for this toolkit, we found it useful to present relevant financing innovations for them as the boundaries between for-profit and non-profit are blurring in the impact economy.

Additional information on the toolkit such as case studies, additional documents, and resources can be found on the **website.** We commit to providing consistency in the structure used to analyse each of the innovative financing instruments. However, from time to time the structure has been adjusted in order to improve clarity and understanding for the reader.

Innovative Financing Instruments for Early-Stage Impact Enterprises - Overview

1 Equity Alternatives and Convertibles

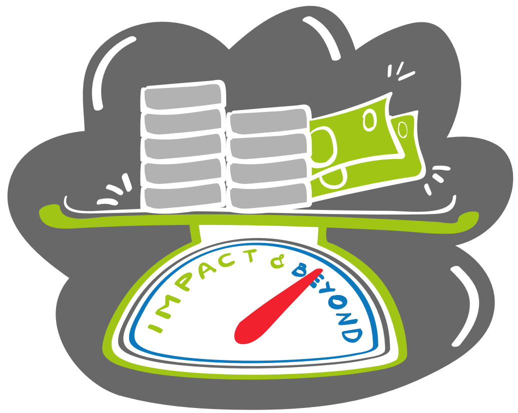
Instrument	Short Description	Typically Provided by: Private Investor*	Institutional Investor**	DFI or Donor***
SAFE (Simple Agreement for Future Equity	Simple option for discounted future equity, alternative for convertible note	✓		
Convertible Note	Loan converting in discounted future equity		✓	
Revenue Share Agreement (Equity Based)	Equity redemption based on revenue share - replacing dividends and exit	✓	✓	
Revenue Share Agreement (Debt Based)	Loan with participation on revenues replacing interest rates and repayment		✓	

2 Catalytic Impact-Linked Finance instruments - Attracting Private Investment (Blended Finance)

Instrument	Short Description	Typically Provided by: Private Investor*	Institutional Investor**	DFI or Donor***
SIINC (Social Impact Incentives)	Premium payments to enterprises for achieving social impact - in combination with private investment			✓ (in combination with Impact Investment)
Reimbursable and convertible SIINC	Reimbursable or convertible premium payments to enterprises for achieving social impact - in combination with private investment			✓ (in combination with Impact Investment)
Impact-Ready Matching Funds (IRMF)	Matching funds for building up an impact management system - in combination with seed capital			✓ (in combination with Impact Investment)

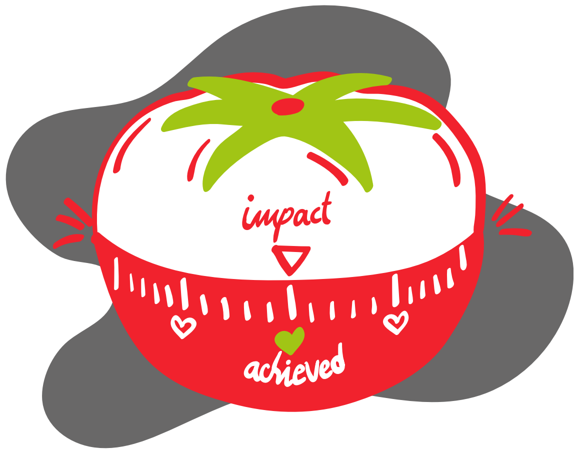
*Private Impact Investor, e.g. Business Angel
**Institutional Impact Investor, e.g. Impact Fund
***Development Finance Institution or International Donor, e.g. Development Bank/Agency

3 Other Impact-Linked Finance Instruments		Typically Provided by:		
Instrument	**Short Description**	Private Investor*	Institutional Investor**	DFI or Donor***
Impact-Linked Loan	Loan with impact-linked interest rates and potentially loan forgiveness ("better terms for better impact")		✓	✓
Impact-Linked Convertible Note	Loan with impact-linked interest rates and option for discounted future equity ("better terms for better impact")		✓	



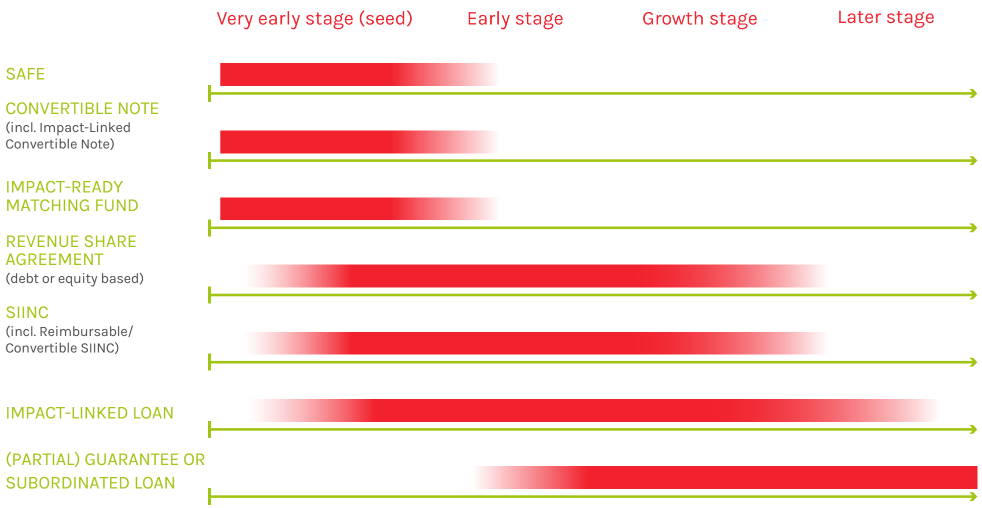
4 Other catalytic funding instruments - attracting additional investment (Blended Finance)		Typically Provided by:		
Instrument	**Short Description**	Private Investor*	Institutional Investor**	DFI or Donor***
(Partial) Guarantee	(Partial) risk coverage in order to attract additional investment			✓ (in combination with Investment)
Subordinated loans as catalytic first-loss capital	Subordinated capital in order to attract additional investment			✓ (in combination with Senior Loan)

5 Results-based Finance instruments for non-profit organisations		Typically Provided by:		
Instrument	**Short Description**	Private Investor*	Institutional Investor**	DFI or Donor***
Social/Development Impact Bond	Investors providing pre-financing for non-profit interventions and paid back with return when social impact targets are met		✓ (pre-financing)	✓ (outcome-based funding)
Performance-based Contract	Payments to non-profit organisations conditional to achieving social impact			✓



It is important to note that the current financial regulatory regime only allows licensed financial intermediaries (banks and financial institutions) to receive interest against debt investments through loans.

In which stage to use the different financing instruments for impact enterprises



Note: The graph illustrates the most typical use of the instruments for impact enterprises. However, variations are possible depending on the willingness and ability of the financing provider to act more or less catalytic and take more or less risk. For example, a guarantee could also be provided for an early stage enterprise in order to attract additional capital providers.

Islamic Finance

Bangladesh is home to different religious groups, of which the Muslim population makes up for the majority of the population, thus influencing how business is run. In fact, personal law aspects of the day to day life of Bangladeshi Muslims are governed by the Islamic religious law known as “Shariah”, including entailing important implications on how the banking and investment landscape operates where Bangladeshis choose to partake or do banking through the Islamic banking system.

Islamic Finance is a set of financing activities within the framework governed by the principles of the Shariah that has been gaining momentum over the past years and it represents a fast-growing segment of the financial market. Although some of the instruments listed in this toolkit could be already in compliance with Islamic Financing requirements, you should seek professional legal advice in order to successfully implement the instruments described.

Legal disclaimer

The content of this toolkit and the materials on the website have been prepared for informational and educational purposes only, and do not constitute legal advice or a substitute for legal counsel or any other professional advice. You should seek independent advice from financial, tax, and legal advisors in connection with, or independently research and verify, the information that you find on our website and/or in this toolkit and wish to rely upon it. Although best efforts are made to ensure the highest level of accuracy and that the information is up to date (third quarter 2020), occasionally unintended errors and misprints may occur.

Furthermore, the site offers hyperlinks to other websites thereby enabling to access further information from internal and external sources. The authors are not responsible for the content of any linked site or any link in a linked site, which are not under their control but that can be modified by third parties.

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Legal information about the use of financing instruments described in this toolkit

The information contained herein should not be implemented without prior consultation of legal advice, and the instruments explained in this toolkit should never be used without first assessing their compliance with all the necessary laws and regulations applicable to the country. The regulatory environment could pose additional challenges to the application and execution of the instruments listed herein due to the intricacies of the legal processes.

For instance, the redemption of equity could be hindered by the regulations on the reduction of capital and share buybacks. According to the Companies Act 1994, under section 58, a company faces restrictions on the purchase by company or loans by company for the purchase of its own shares. Buybacks are subject to restrictive and detailed rules, and a company in Bangladesh may buyback its own shares only upon obtaining an order of the Company Court (High Court Division of the Supreme Court).

Repayments could also face restrictions based on the location of the provider. In fact, all proposals for borrowing from abroad and the respective repayment of interest and principal instalments shall require the prior authorisation of the Bangladesh Investment Development Authority (BIDA), and may also require the approval of the Bangladesh Securities and Exchange Commission (BSEC).

Furthermore, Bangladesh maintains significant control over the foreign exchange market, with comprehensive guidelines on the application and implementation of its foreign currency regime. Remittances to investors based outside Bangladesh are subject to regulatory approvals, and depending on the remittance amount, the structure of the investments as well as the industry of the investee, approvals from the BIDA, BSEC, and the Bangladesh Bank may also be required.

INNOVATIVE FINANCE OVERVIEW

Innovative Finance is a general term typically used for a set of non-traditional investment strategies and structuring approaches that focus on the creation of positive social and environmental impact with the means of finance. Here we provide an overview of the different approaches.

A. IMPACT INVESTMENT

Impact Investments are investments made with the intention to generate positive, measurable social, and environmental impact alongside a financial return. The growing impact investment market provides capital to address pressing challenges in sectors such as sustainable agriculture, renewable energy, conservation, microfinance, and affordable and accessible basic services including housing, healthcare, and education (The GIIN[1]). The main defining criteria for Impact Investment are:

- **Intentionality:** Investors intentionally aim to achieve a positive social or environmental impact with their investments.
- **Financial Return:** Investors expect an impact investment to generate sufficient financial return on capital.
- **Asset class/return rate spectrum:** Impact investment targets a wide range of returns from concessionary [2] to market rate, and across different asset classes[3], depending on the investors' strategic goals.
- **Impact measurements:** Investors are actively engaged in measuring and reporting the social and environmental performance as well as the progress of the underlying financial investment, in order to guarantee accountability and transparency.

It is interesting to note that the gathering of impact data helps the enterprise to better understand its customers and therefore create ad-hoc products and services. On the capital investor's side, impact measurement provides the impact investor with valuable insights to improve everything from deal sourcing to the selection and management of the investment. Reporting data, on the other hand, helps the enterprise and the investor to earn trust with key stakeholders. Thus, measuring impact not only boosts the company's economic results but it also indirectly influences the company's long-term viability.

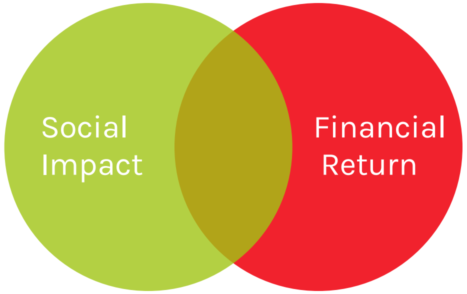


Figure A.1 - "Impact Investment", source: Roots of Impact.

While this report focuses on innovative financing for early-stage impact enterprises, the definition of Impact Investment encompasses a whole range of financial transactions. Examples are equity investment in MFIs[4], debt investment to finance the construction of a wind farm, or royalty-based loan to finance the expansion and working capital needs of an early-stage company providing affordable healthcare. The main impact themes include but are not limited to access to finance, green technology/cleantech, access to basic services, environmental markets and sustainable real assets, sustainable consumer products and employment generation. The prevailing types of impact investors are HNWI[5], institutional funds, DFIs[6], governments, foundations, banks, pension funds, insurance companies and other financial institutions, whereas the main impact investment recipients are startups, impact enterprises, mature companies, and funds.

B. BLENDED FINANCE

According to Convergence, Blended Finance is the use of catalytic capital from public or philanthropic sources to increase private sector investment in developing countries to realize the SDGs.

1 GIIN: Global Impact Investing Network

2 Concessionary: below market rate

3 Asset classes: including but not limited to cash equivalents, fixed income, venture capital, and private equity.

4 MFIs: Micro Finance Institutions

5 HNWI: High Net Worth Individuals

6 DFIs: Development Finance Institutions

Blended Finance is a structuring approach for combining different types of finance from different sources. Despite its numerous combinations, Blended Finance should always have three distinctive characteristics:

- Catalytic nature
- Contribution towards achieving the SDGs
- Yield of positive financial returns[7]

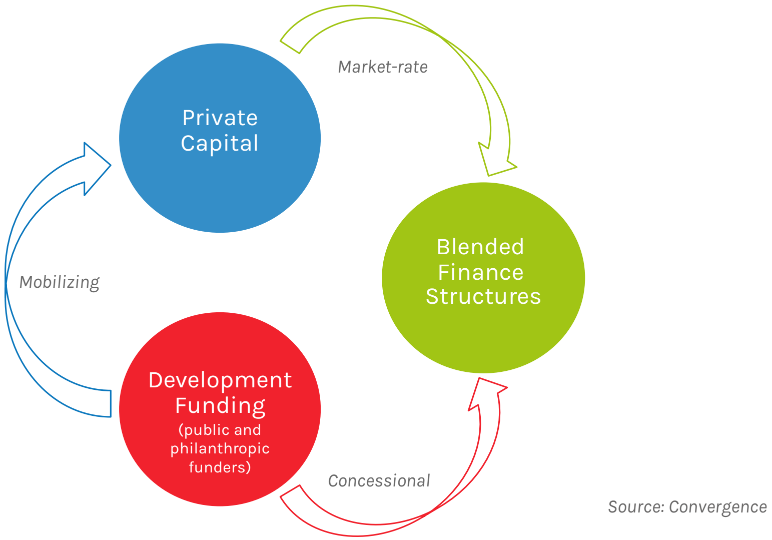


Figure B.1 – "Blended Finance", source: Convergence, 2020

Catalytic capital differs from commercial capital insofar that it typically bears higher risk and/or seeks lower returns. This "concessionality" is what makes it catalytic and allows for the mobilisation of additional investment.

How does Blended Finance work?

Private investors are generally looking for an appropriate return for the level of risk of an investment, i.e. a "risk-adjusted" return. The higher the (perceived) risk, the higher the expected return needs to be to compensate for that risk. Hence, for projects or enterprises that are not meeting the risk-return expectations of private investors, there are two basic ways for public funders to attract them (with possible combinations of both):

- By de-risking the investment – reducing the risk for the private investor
- By return enhancement – increasing the return for the private investor

De-risking with instruments such as guarantees, or first-loss capital is generally used for projects or enterprises that are sufficiently profitable but have a high (perceived) risk of default or write-off. On the other hand, with return enhancement (for example, via technical assistance or Social Impact Incentives), donor agencies and other catalytic funders can support earlier stage projects and enterprises. They can also boost innovations that are not yet commercially viable enough to attract investors but are expected to generate significant positive development outcomes.

C. RESULT-BASED FINANCE

Result-Based Finance is a broad term that refers to all the instruments that provide funding upon achievement of specific results. Given the expansiveness of the definition, Result-Based Finance entails a broad spectrum of interpretations and applications such as performance-based contracts, impact bonds, advance market commitments, and other financial rewards. The essential aim of Result-Based Finance is to provide and encourage more efficient and effective use of public finance and implementation capacity towards the SDGs[8].

D. IMPACT-LINKED FINANCE

Impact-Linked Finance, as a further development of Results-Based Finance, refers to linking financial rewards for market-based organisations to the achievements of positive social outcomes. It is an effective way of aligning positive impact with the economic viability of the investee enterprises. The practice lies at the intersection

7 The financial returns are positive for all the players involved. However, based on the structure decided some investors may have above market returns and some others may only have concessional returns

8 SDGs: Sustainable Development Goals

between Blended Finance, Impact Investing, and Results-Based Finance. It bears many similarities to Results-Based Finance but differs in two key points: Firstly, it is used to catalyse private investment for businesses, as opposed to just providing payments for results. Secondly, it is rewarding the achievement of outcomes (e.g., decent jobs and increased income for target beneficiaries) as opposed to outputs (e.g., people trained). It thus represents financing for businesses that are willing and able to deliver positive impact beyond the usual scope.

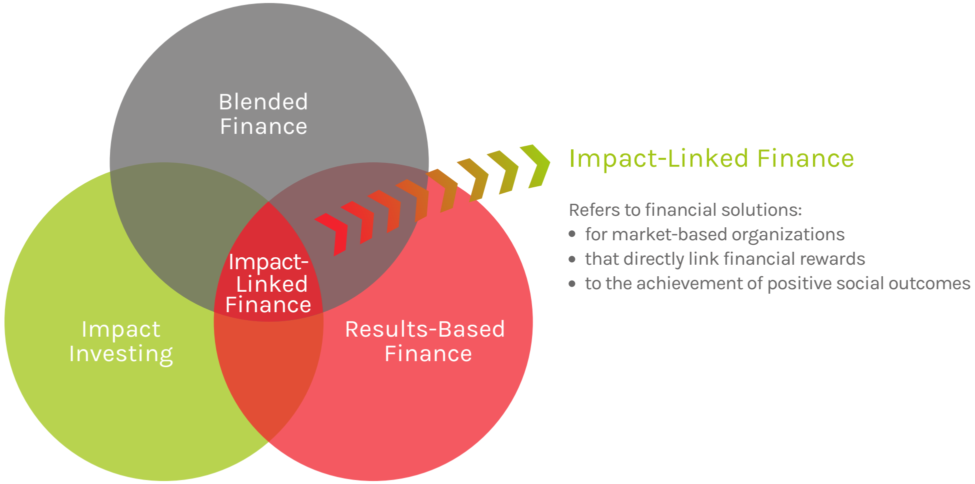


Figure D.1 – "Impact-Linked Finance",
source: Boston Consulting Group and Roots of Impact.

The practice of Impact-Linked Finance follows the concept that rewards for positive outcomes can be built into financing instruments across the board, from equity and debt to guarantees. For example, lenders can link the interest rates of loans to pre-defined impact performance metrics, decreasing the rate as this impact is achieved. Here, the ‘impact-linked loan’ effectively lowers financing cost and creates a strong incentive for enterprises to outperform on positive impact.

EQUITY ALTERNATIVES AND CONVERTIBLES

1

The following section examines four financing instruments for early-stage impact enterprises with self-liquidating mechanisms or convertible options.

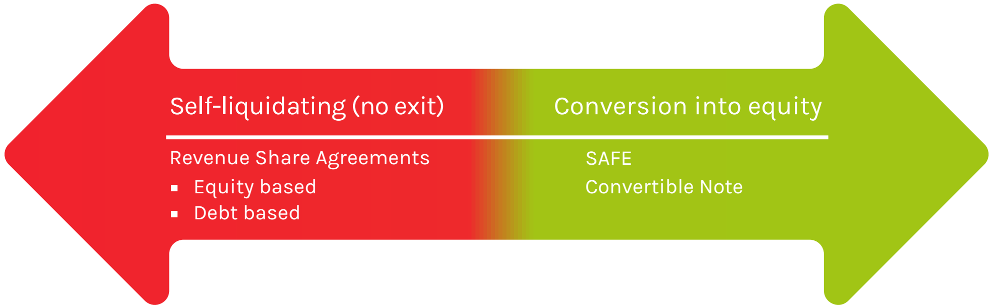


Figure 1.1 – "Equity Alternatives and Convertibles", source: Roots of Impact.

1. 1 SAFE (SIMPLE AGREEMENT FOR FUTURE EQUITY)

Brief Description

The Simple Agreement for Future Equity ("SAFE") is a financing instrument used in early-stage funding and seed funding, and resembles the dynamics of a convertible note without having the intricacies that a convertible debt instrument would entail. Via a SAFE the investor receives the right to purchase the shares of a company in a future round of equity, subject to pre-defined conditions set ex-ante in the agreement.

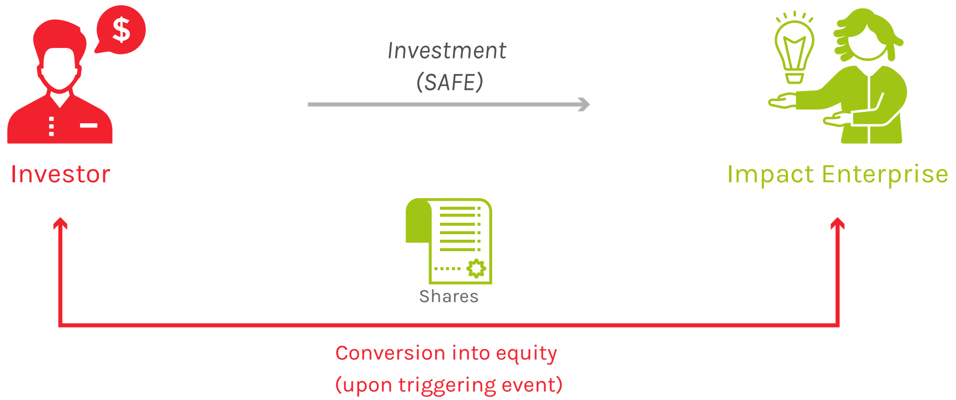


Figure 1.2 - "SAFE", source: Roots of Impact.

Purpose/Fit	Flexible, quick and simple source of funding in unpriced[9] seed rounds
Can replace	Debt – convertible notes
Risk/Return Profile	High Risk/High Return
Enterprise Lifecyle	Seed stage
Maturity	n/a – it is linked to the equity funding round (or dissolution event, or another triggering event)

9 Unpriced in this context means that there is no company valuation that would allow to calculate the company share investors would get for a certain amount of investment.

Emergency-Proof: This instrument is particularly relevant in difficult historical moments such as the Covid-19 crisis when flexibility and quick access to funding are critical to overcoming the severe social, financial, and economic challenges faced by enterprises.

Defining Criteria

- **Liquidity event or triggering event:** A specific event triggering conversion into equity. The most common event is an equity funding round (it is usually a series A financing, i.e. when the company provides equity shares to the investors for the first time). Another triggering event could be a trade sale, which is the sale of the overall business, or a part of it, to another company.
- **Dissolution event:** In the case of the company going out of business, the SAFE investor is entitled to receive its purchase amount or any other agreed amount back.
- **Discount rate:** It allows the SAFE investor to convert to equity at a discounted price in the course of a subsequent round of financing. Discount rates typically range between 10% and 25%, and the discount factor is calculated as follows: [100 – discount rate]%.
- **Valuation Cap:** Upon raising funds above a certain threshold, it allows the SAFE investor to convert at the cap share price. The valuation cap works as a ceiling on the valuation that will be used to calculate the conversion price for the SAFE investors, which are entitled to convert at the lower of the valuation cap or the price, in the subsequent financing.
- **Pro-rata rights or participation rights:** They entitle the SAFE investors, during subsequent rounds of funding, to invest additional funds in order to maintain their ownership percentage and avoid dilution.

Interesting Variants and Options

- The triggering event can also be linked to a change of control, an M&A, or other predefined circumstances.
- The valuation cap can be applied to pre [10] or post [11] money valuation.
- Most favoured nation provision ("MFN"): in case of multiple issues of SAFE, the company has to inform all the SAFE investors about each new additional issuance and enable them to check whether the terms are preferable. For instance, if a valuation cap or discount is introduced in the new round of SAFE, then the previous holders are entitled to amend their SAFE to reflect the new terms.
- Linking financial rewards to the achievement of impact, for example reducing the discount rate or increasing the valuation - see "Examples of relevant terms" below.

Examples of SAFE structures

- SAFE with valuation cap but no discount (most common)
- SAFE with no valuation cap but with discount
- SAFE with both valuation cap and discount

Examples of relevant terms (as formulated in a contract):	
Discount Factor/Price	The Discount Factor is (80%). The Discount Price is the price per share of the Standard Preferred Stock sold in the Equity Financing multiplied by the Discount Factor.
Conversion Price	The Conversion Price means either (i) the SAFE Price or (ii) the Discount Price, whichever calculation results in a greater number of shares of SAFE Preferred Stock, where SAFE Preferred Stock means the shares of Preferred Stock issued to the SAFE investor in an Equity Financing, having identical rights, privileges, preferences and restrictions as the shares of Standard Preferred Stock, other than with respect to (i) the per share liquidation preference and the conversion price for purposes of price-based anti-dilution protection, which will be equal the Conversion Price; and (ii) the basis for any dividend rights, which will be based on the Conversion Price.
SAFE Price	SAFE price means the price per share equal to the Valuation Cap divided by the Company Capitalisation.
Valuation Cap	The (Post-Money) Valuation Cap is (USD 5,000,000)
MFN Amendment Provision	If the Company issues any Subsequent Convertible Securities prior to termination of this SAFE, the Company will promptly provide the Investor with written notice thereof. In the event the Investor determines that the terms of the Subsequent Convertible Securities are preferable to the terms of this instrument, the Investor will notify the Company in writing. Promptly after receipt of such written notice from the Investor, the Company agrees to amend and restate this instrument to be identical to the instrument(s) evidencing the Subsequent Convertible Securities.
Optional: Link to Impact Performance	• The pre-agreed discount rate of (20%) is reduced by (1%) for every (1,000 units of social outcomes) achieved by the Company up to a discount rate of (0%) • Alternatively: The pre-defined valuation cap of (USD 5,000,000) increases by (USD 10,000) for every (1,000 units of social outcomes) achieved by the company up to a valuation cap of (USD 8,000,000)

10 Pre-money refers to the value of a company prior the latest round of financing.

11 Post-money refers to the value of a company right after a financing round.

Main Advantages

- SAFE allows companies to raise investment along their natural company's value growth curve, without having to sell a high percentage of their company at a low valuation in the early stage of their lifecycle. Thus, SAFE allows companies to raise money at an appropriate time.
- The legal costs associated with the draft and implementation of the agreement are low and far from being comparable to other forms of financing.
- SAFE allows for greater flexibility as there is no maturity, and therefore no fixed deadline for conversion.
- Using a valuation cap, the investors can lock in their economics by exactly knowing which percentage of the company they will theoretically own as a result of their investment.

Main Challenges

- Similar to equity instruments, there is no recovery provided in the case of bankruptcy.
- Investors could prioritise owning preferred stocks, which would enable them to receive control rights, board seat, veto rights, and/or other economic rights.
- Investors are not remunerated [12] for the early-stage risk they are taking. In fact, they get paid only when the company raise additional funding.
- Unlike debt instrument, a SAFE does not accrue interest and it lacks a maturity date, which entails that there is no guarantee of equity ownership for the investor.

(Hypothetical) Example of SAFE

Company ImpactFly is a startup that aims to revolutionize the use of drones to measure access to electrification and clean drinking water in rural areas. The company is evenly owned by two founders (2 million shares each, 4 million in total) who decide to raise capital via a USD 500,000 SAFE offered by an investor. Once the agreement is signed, the two founders can use the money received to process the building of their venture. After 16 months the company is booming and the sales pipeline is skyrocketing, but the company is still not profitable and ImpactFly needs to raise additional funds (e.g. Series A round) in order to scale their business. The two founders approach a venture capital fund to raise an additional USD 1 million for 25% of the ownership, translating into a pre-money valuation of USD 4 million.

12 It could be argued that the discount rate compensates the investor for the additional risk borne.

Summary of information

- Pre-money valuation of USD 4 million
- Number of outstanding shares of 4 million
- SAFE Investment of USD 500,000
- Share price pre-money of USD 1

Let's look at the transaction under three different scenarios:

The SAFE is offered with a 15% discount
- The SAFE investor is entitled to a discount of 15%, therefore he or she will be able to convert at 85% of the price, providing the investor with 11% of the post-money (USD 5 million) ownership.

The SAFE is offered with a valuation cap of USD 3 million
- The SAFE investor is entitled to convert at 75% of the price as a result of a valuation cap of USD 3 million, providing the investor with 12% of the post-money (USD 5 million) ownership.

The SAFE is offered with a 15% discount and a valuation cap of USD 3 million
- The investor is entitled to convert at the minimum price between the discount price and the valuation cap price. In this case, the investor would apply the cap allowing him or her to obtain a 12% ownership instead of 11%.

Case studies and additional resources about SAFE can be found here.

1. 2 CONVERTIBLE NOTE

Brief Description

A Convertible Note is a short-term unsecured debt instrument that will convert into equity upon the occurrence of a triggering event. For example, when the convertible note is used as a seed financing[13], the triggering event is usually the closing of a series A [14] equity round of financing. The underlying idea is that the investor receives shares [15] of the company and dividend payments in lieu of principal and interest payments. After the triggering event, the investor is entitled to convert at the lower of (i) the price of the financing round (after applying a discount rate, if any) and (ii) the valuation cap (if any).

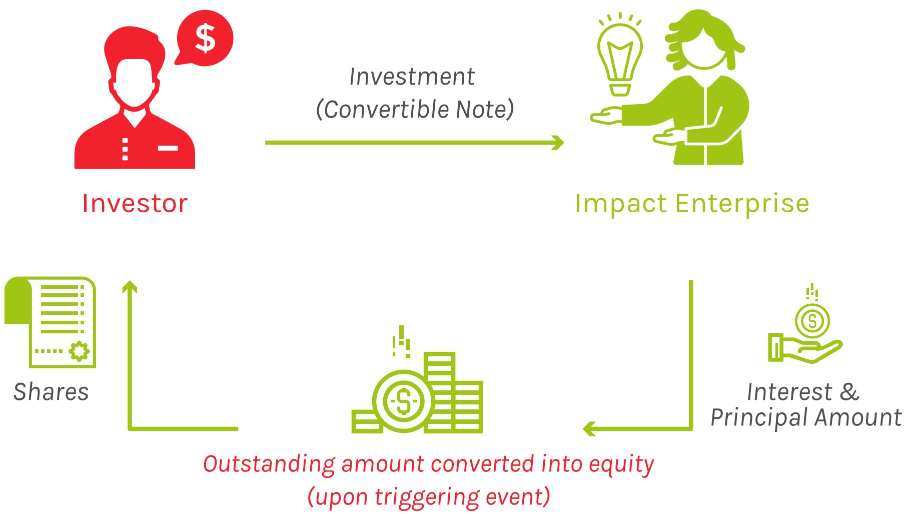


Figure 1.3 – "Convertible Note", source: Roots of Impact.

13 It usually refers to the first official round of funding of a startup, on top of the capital invested by the founders, close friends, family, and first supporters, which usually provide the pre-seed funding.

14 It is the round of funding subsequent to the seed financing. Startups usually raise capital via a Series A round when they have already developed a track record that shows the potential for further business expansion.

15 Usually preferred stocks.

Purpose/Fit	Flexible, quick and simple source of funding in unpriced [16] seed rounds
Can replace	Equity, SAFE, debt – conventional loan
Risk/Return Profile	High Risk/High Return
Enterprise Lifecyle	Seed stage
Maturity	It depends on the maturity date defined ex ante

Emergency-Proof: This instrument is particularly relevant in difficult historical moment such as the Covid-19 crisis, when flexibility in repayments is critical to overcoming the severe social, financial, and economic challenges faced by enterprises.

Defining Criteria

- **Triggering event:** It is usually an equity funding round.
- **Discount rate:** It allows the investor to convert to equity at a discount price during a later round of financing. Discount rates typically range between 10% to 25%, and the discount factor is calculated as follows: [100 – discount rate]%.
- **Valuation Cap:** Upon raising funds above a certain threshold, it allows the investor to convert at the cap share price. The valuation cap works as a ceiling on the valuation that will be used to calculate the conversion price for the convertible note investors, which are entitled to convert at the lower of the valuation cap or the price, in the subsequent financing.
- **Interes rate:** The convertible note is a hybrid debt instrument, and as such it has an interest rate. Unlike a traditional loan, however, the interest is typically not paid until maturity date. Furthermore, in the majority of the cases the interest coverts into equity instead of being paid in cash.

16 Unpriced in this context means that there is no company valuation that would allow to calculate the company share investors would get for a certain amount of investment

- **Maturity date:** Once the maturity date is reached, and no conversion has happened, then the company must pay back the principal and the interests accrued or convert into equity.

Interesting Variants and Options

- The triggering event could be linked to a change of control, an M&A, or other predefined circumstances
- In the case of a Convertible Note with Revenue Share Agreement, the schedule payment of the interest could be linked to a revenue share agreement.
- Linking financial rewards to the achievement of impact, for example reducing the discount rate or increasing the valuation cap – see "Examples of relevant terms" below.

Examples of Convertible Note structures

- **Traditional Convertible Note:** The outstanding amount composed by the amount initially provided by the investor and the interest payments accrued, are converted into common shares at the lower of the valuation cap or the price at the next qualified financing.
- **Convertible Note with Revenue Share Agreement instead of interest payments:** Unlike a traditional convertible note the interest payment are not accumulated throughout the period but a share of the revenues is periodically paid in order to provide the investor with a return before the maturity date.
- Convertible Note with valuation cap but no discount.
- Convertible Note with no valuation cap but with discount.
- Convertible Note with both valuation cap and discount.

Examples of relevant terms (as formulated in a contract):	
Conversion	The outstanding balance of the Note's principal together with all accrued and unpaid interest under the Note shall be converted into shares of the company's capital stock pursuant to the Qualified Equity Financing to the lower of (i) a conversion price equal to (80%) (Discount Factor) of the price per share agreed to in the Qualified Equity Financing, and (ii) a conversion price equal to Valuation Cap divided by the fully diluted capitalisation as of immediately prior to the initial closing of the Qualified Equity Financing.
Discount factor	The Discount Factor is (80%).
Valuation Cap	The Valuation Cap is (USD 4,000,000).
Optional: Link to Impact Performance	• The pre-agreed discount rate of (20%) is reduced by (1%) for every (1,000 units of social outcomes) achieved by the company up to a discount rate of (0%). • The pre-defined valuation cap of (USD 4,000,000) increases by (USD 10,000) for every (1,0000 units of social outcomes) achieved by the company up to a valuation cap of (USD 6,000,000).

Main Advantages

- Considerable dilution of early investors is prevented.
- No valuation questions at the very early stage of financing, and thus no problems of ownership percentage, taxes and option pricing.
- It is a rather simple, fast and cost-effective way to raise funds (while SAFE is even simpler).
- Founder control is not diluted.

Main Challenges

- Investors could prioritise owning preferred stocks, which would enable them to receive control rights, board seat, veto rights, and/or other economic rights.
- Investors are not remunerated [17] for the early-stage risk they are taking. In fact, they get only paid once the company raises additional funding.
- If a Convertible Note is issued without a valuation cap, there is the risk of a misalignment of interest between the founders and the investors. In fact, the investors would be penalized by a high valuation and thus could be incentivized to refrain from helping the enterprise to maximize its value.

Case studies and additional resources about Convertible Note can be found here.

17 It could be argued that the discount rate compensates the investor for the additional risk borne.

1. 3 REVENUE SHARE AGREEMENT (DEBT-BASED)

Brief Description

A Revenue Share Agreement ('RSA") is a quasi-equity financing instrument (also called revenue-based loan) where periodic repayments are based on a percentage of the revenues up to a predetermined return on the investment ("Cap" or "Multiple").

The RSA allows for higher level of flexibility because the repayments are not tied to a monthly amount or interest rate, but they fluctuate with the company's revenues allowing for greater flexibility. Hence, when revenues are down due to seasonality or other unexpected factors, the repayment will be lower, and it will represent a smaller burden on the company's cashflow.

Conversely, when revenues are high, the repayment will scale with the increasing revenue base and it will allow the investment to be repaid faster.

The RSA debt-based allows to retain ownership and control of the company, avoiding equity dilution or interferences in the management by external parties.

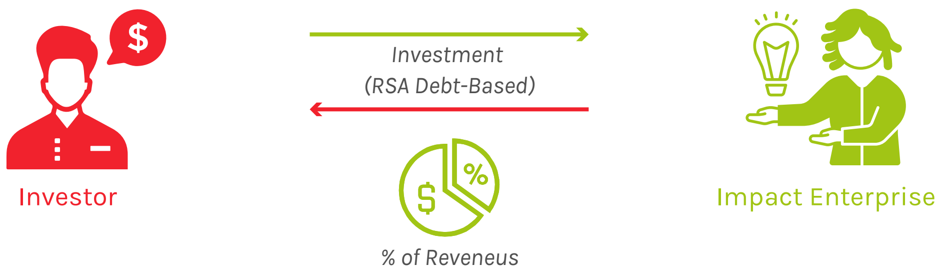


Figure 1.4 - "RSA Debt-Based", source: Roots of Impact.

Emergency-Proof: This instrument is particularly relevant in difficult historical moment such as the Covid-19 crisis, when flexibility in repayments is critical to overcoming the severe social, financial, and economic challenges faced by enterprises.

Purpose/Fit	Enabling for mission-aligned growth without equity dilution and requirement for exit
Can replace	Equity or debt (dependent on stage and purpose of investment)
Risk/Return Profile	Medium Risk/Average Return[18]
Enterprise Lifecyle	Early-growth stage (post-revenue)
Maturity	Agreed between investors and borrowers based on a pre-defined multiple

Defining Criteria

- **Interest rate:** Unlike a loan or a convertible note, a Revenue Share Agreement has no fixed interest rate.
- **Periodic repayments:** They are based on a fixed percentage of revenues, or alternatively profit, cashflow or other financial indicators. The frequency is usually annually or biannually.
- **Revenue share:** It represents the percentage of the revenue agreed that the company shall pay to the investor.
- **Revenues:** It represents the definition of revenues agreed with the company. An example is the definition of net revenues according to common accounting standards.
- **Multiple/Cap:** It represents how many times the initial investment ("Multiple") or the total amount ("Cap") the enterprise shall repay.
- **Flexibility:** A Revenue Share Agreement has a flexible repayment period, until reaching a pre-defined multiple (e.g. 1.5x initial investment).
- **Return on capital:** The investor's return on capital is dependent on the timing of the repayments. Hence, the faster the sales growth, the greater the return for the investor.

18 The return depends on the behaviour of the underlying financial metric and on the speed of which money is repaid back.

- **No collateral requirement:** Typically, there is no requirement for collateral but simply a convincing revenue history or high potential for future sales given proof of concept[19] or past traction.

Interesting Variants and Options

- Honeymoon[20], also known as grace period. Useful to provide the enterprise with the needed time to reach efficient scale.
- A final repayment date for the remainder can be agreed upon. In this case the enterprise has to pay the investor the remainder (balloon payment) for reaching a pre-defined multiple (e.g. 1.5x) on this final repayment date.
- Straight interest rate that is enhanced with a "royalty kicker", i.e. a percentage of revenues payable to the investor on top of the straight repayment (which dilutes some of the advantages for the enterprise, mentioned before).
- Conversion to equity or participation rights in future rounds of funding (see convertible note).
- The loan could be combined with business development services in order to prepare the entrepreneur ("the borrower") for loan monitoring, business growth, capital infusion, and help to reduce the risk of default.
- The investor could be provided with the option to convert his or her investment to a normal loan upon achievement of a specific revenue level. In that way, the enterprise will pay back as they would do with a traditional loan schedule, thereby providing the creditor with interest principal payments. This variant offers the possibility to put a cap on the amount of money the enterprise will have to pay to the investors, and it helps them to make more accurate future financial projections.
- The Revenue Share Agreement can be used in combination with subordination of the loan, thus allowing the impact enterprise to attract further funding and investors (subordinated debt[21]).
- Linking financial rewards to the achievement of impact, for example reducing the multiple/cap or the revenue share – see "Examples of relevant terms" below.

Example of Revenue Share Agreement Debt-Based structures

- Straight (or Open Ended) Revenue Loans: A percentage of the revenues is periodically repaid until a certain multiple of investment is reached.
- Convertible Revenue Loans: A percentage of the revenues is periodically repaid, and the remainder can be converted to equity.
- Final Repayment Date Revenue Loans: The remainder has to be repaid until a final repayment date.

19 Proof of Concept ("PoC") is the evidence of technical feasibility of a business model and practicability of an idea or of a new project. It is usually carried out to demonstrate that a project has potential to be developed further.

20 The repayment is deferred by a predetermined duration, usually ranging from 10 to 24 months, in order to allow the enterprise to accelerate its growth and generates revenues and profits

21 In the event of liquidation or bankruptcy the subordinated debt ranks below the other debt instruments. Therefore, all the other creditors' claims must be met before starting to pay the owner of a subordinated debt.

Examples of relevant terms (as formulated in a contract):	
Revenue share	In exchange for the Financing Amount, the Company shall make (quarterly) payments equal to (5%) of Revenue to the Investor until the Repayment Amount is paid in full. The initial payment will begin at the earlier of (i) the end of the first quarter in which the Company generates (gross) revenues of (USD 80,000); or (ii) (12) months (grace period) from signing of the term sheet.
Mulitiple/Cap	• The outstanding amount will be considered paid in full when the Company has paid the investor the Repayment Amount, defined as the original investment amount multiplied by (2x) (Multiple). • In the event the Revenue Share Agreement Debt-Based facility has been in effect for a period of (5) years without full repayment, the Company must repay (2x) the outstanding amount at the subsequent end of quarter.
Optional: Link to Impact Performance	• The pre-defined multiple of (2x) is reduced by (0.1) for every (1,000 units of social outcomes) achieved by the company up to a threshold of minimum (1.2x). • Alternatively: The pre-agreed revenue share of (3%) is reduced by (0.125%) for every (1,000 units of social outcomes) achieved by the company up to a revenue share of (2%).

Main Advantages

- Enterprise and investor both benefit in case of strong revenue growth (alignment of interest).
- Pre-defined exit: self-liquidation through achieving of pre-defined repayment level.
- Straightforward implementation without notary.
- No periodic pre-defined payment amount and no or less requirement for collateral.
- No dilution of ownership.
- It provides the investors with early returns from the investment instead of waiting for an exit.
- There is no time waste on valuation questions.

Main Challenges

- Payments based on revenue share reduces the free cash flow during scaling phase.
- The investor relies heavily on the company's future earnings.
- Additional risk if revenue falls below expectations because it will extend the time of repayments (in case of Straight Revenue Loans) or creates a high repayment obligation at maturity (in case of Final Repayment Date Revenue Loans).
- There is an upper constraint on return in terms of multiple of investment, due to the nature of the structure of the Revenue Share Agreements.

Case studies and additional resources about Revenue Share Agreement (Debt-Based) can be found here.

1. 4 REVENUE SHARE AGREEMENT (EQUITY-BASED)

Brief Description

A Revenue Share Agreement ("RSA") Equity-Based is an alternative equity financing model which incorporates a predetermined distribution structure to investors based on revenues, for a specified period of time or up to a predetermined return on the investment ("Cap" or "Multiple").

As for the RSA Debt-Based, it allows for greater flexibility because the repayments are not tied to a monthly amount or interest rate, but they fluctuate with the company's revenues. Hence, when revenues are down due to seasonality or other unexpected factors, the repayment will be lower, and it will represent a smaller burden on the company's cashflow.

Conversely, when revenues are high, the repayment will scale with the increasing revenue base and will allow for the investment to be repaid faster.

Unlike RSA Debt-Based instruments which treat the revenue share payments as a mix of interest and principal payments, the RSA Equity-Based instruments include a predetermined liquidation mechanism in the form of an equity redemption-based exit.

The self-liquidating structure allows the investors to obtain a return on the investment without having to sell the shares to other investors or relying on subsequent rounds of financing to exit their investment. At the same time, the control of the company is maintained by the entrepreneur and the enterprise performance is matched with the return needs of the investors.

Emergency-Proof: This instrument is particularly relevant in difficult historical moments such as the Covid-19 crisis, when flexibility in repayments is critical to overcoming the severe social, financial, and economic challenges faced by enterprises.

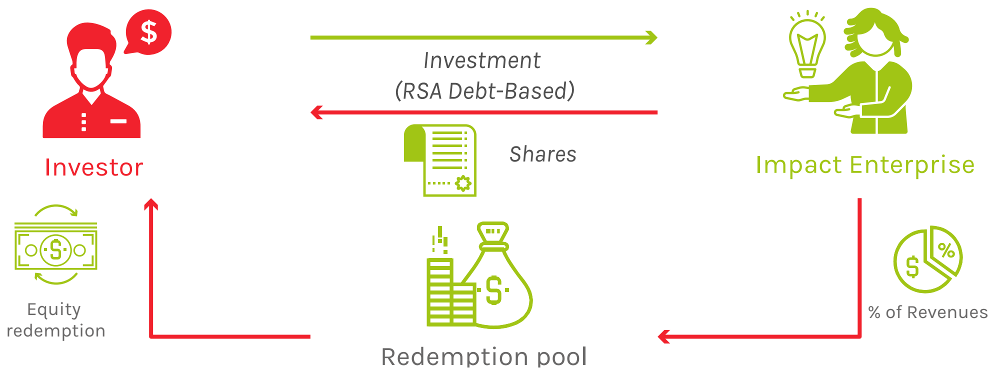


Figure 1.5 - "RSA Equity-Based", source: Roots of Impact.

Purpose/Fit	Enabling for equity-like terms without the need for an exit (share sale [22])
Can replace	Equity
Risk/Return Profile	Medium Risk/Average Return[23]
Enterprise Lifecyle	Early-growth stage (post-revenue)
Maturity	Agreed between investors and borrowers, or upon achievement of a pre-defined milestone

Defining Criteria

- **Revenue share:** It represents the percentage of revenue agreed that the company shall pay to the investor.
- **Revenues:** It represents the definition of revenues agreed with the company. An example is the definition of net revenues according to common accounting standards.
- **Payments:** Revenue Share Agreement (Equity-Based) requires ongoing payments (e.g. annually) based on a pre-determined percentage of revenues (or other financial metrics).

22 A share sale is the sale of parts of the firm or the firm as a whole by selling the shares to another investor

23 The return depends on the behavior of the underlying financial metric and on the speed at which the money is repaid

- **Multiple/Cap:** It represents how many times the initial investment ("Multiple") or the total amount ("Cap") the enterprise shall repay.

- **Profit distribution:** Redemption of equity and or revenue sharing often replaces the right to participate in profit distribution.

- **Self-liquidating:** Higher potential upside return from an exit is traded for more certain repayment terms and less risk (risk-adjusted return shift).

Interesting Variants and Options

- The cap for redemptions can be predetermined at inception as a specific multiple of the original investment price (most common).

- Instead of sharing revenues, it can be agreed to share positive cash flow or profits (Profit Share Agreement - quite similar to traditional equity).

- A redemption pool can be created by setting aside a percentage of revenue over time (similar to a sinking fund [24]). The redemption pool would allow the investors to receive a stable cashflow over the investment period and provide an even greater level of flexibility to the enterprise, enabling it to retain precious resources when it needs them the most. In fact, when revenues are high, the repayment will still scale with the increasing revenues (and the redemption pool will be filled in), whereas when revenues are low, the repayment will come partially or fully from the pool of money set aside.

- A redemption can also be carried out through recapitalization. Once the company is able to obtain traditional financing, conventional instruments (e.g. debt) can be used to buy back shares and reduce the company's outstanding position.
- Being the repayments linked to the financial health of the company and until reaching a specified multiple, the overall return is usually capped. Nevertheless, it could be introduced the possibility for the investor to participate in higher return in the case of a successful traditional exit before maturity.

24 A sinking fund is a sum of money that is set aside as a reserve in order to soften the hardship of a large payment amount. It is usually used to pay off big debt disbursements like bonds.

- A clause can be included in the term sheet to account for higher flexibility in the event that the enterprise does not have adequate cash at its disposal to satisfy the repayments.

- A straight equity conversion option could be included to allow for participation in subsequent equity fund raisings (see convertible note or SAFE).

- Event of default clauses could be implemented if the enterprise does not reach predetermined levels of growth or impact metrics. In order to incentivize the focus on the impact mission, a clause could state that failing to meet specific impact metrics, could translate into a breach of the contract and therefore terminate the relationship. In that case, the firm obligation would be considered as "defaulted" and the subsequent claim on the paid-in capital would arise. Similarly, if the company fails to grow at a predefined rate, then the clause could oblige the company to terminate the relationship and repay back the invested capital. This variant enables to maximize the utility coming from the allocation of capital, in fact since investments are constraint and the number of needy enterprises is high, the clause allows the investor to hedge against the risk that a company fails to perform adequately (both in terms of growth and in terms of impact generated).

- Linking financial rewards to the achievement of impact, for example reducing the redemption cap or the revenue share – see "Examples of relevant terms" below.

Examples of Revenue Share Agreement Equity-Based structures

- **End-of-period equity redemptions:** Shares are redeemed at the end of the investment period through a mandatory repurchase of the equity stake based on the fair market value that could be calculated using, for instance, a third-party valuation.

- **Gradual equity redemptions:** Shares are gradually redeemed over the investment period at a predetermined price and recurrence based on a pool of cashflows previously set aside for periodic redemptions.

- **Percentage-based dividends:** A dividend based on a specific percentage of profit (if the company is profitable) is paid until a target multiple is reached. After the investment period, outstanding shares are repurchased at their original price.

Examples of relevant terms (as formulated in a contract):	
Revenue share	In exchange for the Financing Amount, the Company shall make (quarterly) payment contributions equal to (5%) of Revenue to the Redemption Pool, which shall be utilised at termination of the contract to redeem the Redeemable Amount in full. The Revenue Share Agreement Equity-Based shall be gradually redeemed commencing any time at the earlier of (i) the end of the first quarter in which the Company generates (gross) revenues of (USD 50,000), or (ii) (12) months (Grace Period) from signing of the term sheet. The Revenue Share Agreement Equity-Based shall participate with distribution paid on Common Stock until total amount paid on the Revenue Share Agreement Equity-Based have reached the Redeemable Amount in full.
Mulitiple/Cap	The outstanding amount of the Revenue Share Agreement Equity-Based will be considered paid in full when the Company has redeemed 100% of the Redeemable Amount, defined as the original investment amount multiplied by (2x) (Multiple [25]). The outstanding amount of the Revenue Share Agreement Equity-Based will be considered paid in full when the Company has redeemed 100% of the Redeemable Amount, defined as the original investment amount increased by a specified return on investment of (12%).
Optional: Link to Impact Performance	The pre-agreed redemption cap (multiple of 2x) can be reduced by (0,1x) for every (1,000 units of social outcomes) achieved by the company up to multiple of (1x) Alternatively: The pre-agreed revenue share of (3%) is reduced by (0.125%) for every (1,000 units of social outcomes) achieved by the company up to a revenue share of (2%)

25 A multiple of the invested capital is used in order to define the overall expected return for the investor. In the case of a (3x) multiple, the enterprise will have to provide the revenue share until reaching (3) times the paid-in capital.

Main Advantages

- Since the repayment is calculated on the company's performance, the enterprise can avoid the burden that would come from fixed repayments during low sales periods.
- Revenue sharing is very easy to understand and to implement, e.g. (3%) of every revenue goes to the investor.
- It allows the investor to recoup part of the invested capital during the investment lifetime without having to wait for an investment exit.
- There are no periodic pre-defined payment amounts and no financial pressure from debt servicing.
- Enterprise and investor both benefit in case of strong revenue growth (alignment of interest).

Main Challenges

- Similar to equity instruments, there is no recovery provided in the case of bankruptcy. However, a clause could be implemented that would oblige the enterprise to set aside a percentage of revenue over time to create a pool of funds to be used in case of bankruptcy.
- Payments based on a revenue share reduce the free cashflow during scaling phase.
- The lack of familiarity with the instruments and the possible transaction costs coming from the legal work needed to structure the deal could be a concern.

Case studies and additional resources about Revenue Share Agreement (Equity-Based) can be found here.

CATALYTIC IMPACT-LINKED FINANCE INSTRUMENTS – ATTRACTING PRIVATE INVESTMENT

2

The following section examines four financing instruments for impact enterprises which resemble characteristics both of catalytic funding, and of rewards for impact. They aim is to financially reward the impact created in order to help the company to attract more capital and boost its development.

Figure 2.1 - "Catalytic Impact-Linked Finance" Instruments to attract additional investment, source: Roots of Impact.

2.1 SIINC (SOCIAL IMPACT INCENTIVES)

Brief Description

Social Impact Incentives (SIINC) is a funding instrument that rewards impact enterprises with time-limited premium payments for achieving social impact. By linking public or philanthropic funding to pre-defined and proven social outcomes, high-impact enterprises can earn extra revenue and improve their profitability, which in turn helps to attract additional investment to scale.

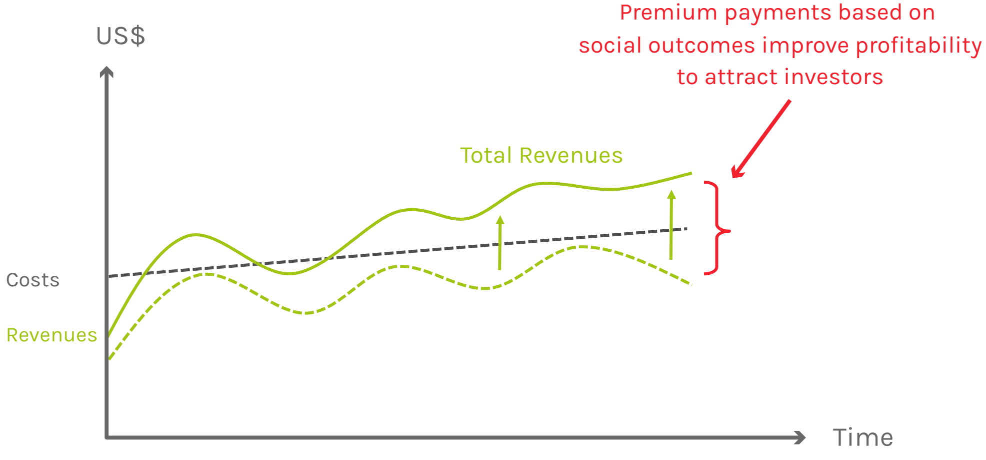


Figure 2.2 - "Business case with SIINC", source: Roots of Impact.

Given that raising repayable investment is a pre-condition for receiving SIINC payments, it can effectively be defined as a blended finance mechanism. In other words, catalytic funds are leveraged to mobilise private investment for impact enterprises.

Emergency-Proof: This instrument is particularly relevant in difficult historical moment such as the Covid-19 crisis, when flexibility in repayments is critical to overcoming the severe social, financial, and economic challenges faced by enterprises.

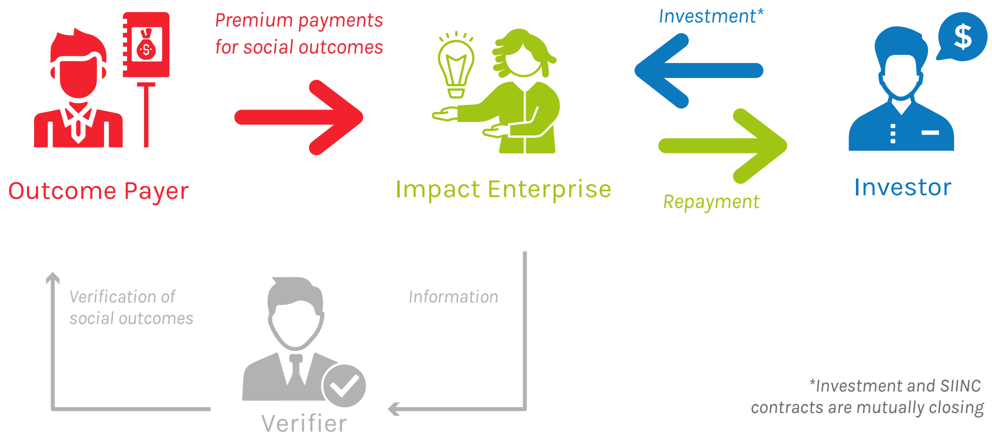


Figure 2.3 - "The Social Impact Incentives (SIINC)", source: Roots of Impact.

Purpose/Fit	Enabling impact enterprises to attract investment and scale both in terms of income and impact Improving the risk/return profile for investors
Can replace	Grants, catalytic capital, and other blended finance instruments
Risk/Return Profile	n/a
Enterprise Lifecyle	Early and later growth-stage
Maturity	2-4 years

Defining Criteria

- **Financial reward for impact:** Ongoing payments to impact enterprises are linked to direct and measurable impact (which aligns profitability with social impact).
- **Outcome verification:** Independent verification of the results (outcomes).
- **Cap for financial rewards:** Premiums are typically provided up to a capped amount.

- **Capital mobilisation:** Mobilisation of private investment (closing condition for SIINC) creates leverage for the catalytic funding provided.

- **Alignment of interests:** Impact enterprises and investors both carry the risk of underperformance for achieving outcomes, and both positively benefit from successful outcome achievements.

Interesting Variants and Options

- **Reimbursable SIINC**
  - Reimbursable SIINC are similar to traditional SIINC, except that the payments received from the outcome payer have to be reimbursed if pre-defined triggers are met.
  - While conditions can be freely negotiated, the most obvious scenario is to tie reimbursement to the commercial success of the enterprise, e.g. using pre-defined profitability triggers.

- **Convertible SIINC**
  - Along the lines of Reimbursable SIINC, Convertible SIINC can also tie a partial or full conversion (e.g. into debt) of SIINC payments to the commercial success of the impact enterprise.

Both of the above mentioned SIINC variants are best suited for high growth ventures that are expected to get commercially strong and both allow outcome payers to "recycle" their resources to generate further impact.[26]

- **Direct integration of SIINC in investment (e.g. Impact-linked Loan)**[27]
  - Social impact incentives can be directly integrated into loans, tying the interest rates (potentially even parts of the repayment obligations) to borrowers' impact – the higher the social outcomes achieved, the better the terms.
  - Possible (re)payments range from discounted interest to partial or even complete forgiveness of interest and principal payments.

- **Emergency SIINC**
  - Conceptualised in response to the Covid-19 crisis, Emergency SIINC build on the idea that if enterprises do not receive additional emergency funding tied to impact, they risk unintended shifts in their business models.
  - Payments can for instance, be tied to the results of an impact enterprise's defensive strategies (e.g. efforts to maintain and protect workforce), or be linked to providing supportive products and services for their most vulnerable customers.

Example of SIINC structures implemented in Latin America

Company description and challenge	SIINC approach
Clinicas del Azúcar (CdA) is a one-stop-shop chain of diabetes clinics serving low income populations in Mexico. As the company is raising investment to scale, it faces the risk of moving towards a middle-income population segment and of compromising on the quality of its service.	SIINC pays CdA for increases of its BoP patients and it ensures that they receive high quality treatment by monitoring their health improvements (HbA1c levels).
Inka Moss works with native high Andean communities in Peru to harvest, process and sell white moss. Although there is high demand for the product, it is difficult to reach and train new communities to increase production.	SIINC payments are disbursed if the company reaches more communities of harvesters and helps them to move to a higher income bracket.
Root Capital is an agricultural lender operating in Latin America for small agricultural cooperatives. Due to the high cost related to lending to smaller and first-time clients, Root Capital struggles to disburse credit to organisations that need it the most.	SIINC rewards Root Capital for disbursing "high additionality loans", meaning loans that the lender would not consider profitable enough. A bonus is granted for gender inclusive businesses.

26 Further details for Reimbursable and Convertible SIINC can be found in a separate factsheet in the next chapter.

27 See Impact-linked Loan factsheet on page 41 for more information.

Examples of relevant terms (as formulated in a contract):	
Raising repayable investment as closing condition	The contract enters into force after the Company submitted evidence of having secured repayable external investments in an amount equating to a minimum of (3.5) times the amount of the SIINC funds eligible for disbursement.

SIINC Payments Example I (diabetes treatment for low income groups):	
Improvement in blood sugar values	**Indicator:** Average improvement in HbA1c values of people from low income households. **Payment system:** every additional (0.2%) improvement in HbA1c values triggers a different payment between (USD 1,000) and (USD 12,500). **Example:** If in a given period, the verified average improvement is of (1.4%), the impact enterprise receives (USD 6,250) in SIINC payments. Total payments are capped to (USD 75,000).
Reach	***Indicator:*** Average growth rate in number of fee-paying patients stemming from Bottom of the Pyramid (BoP) households. **Payment system:** for every additional (2.5%) average growth rate of BoP patients, a SIINC payment between (USD 1,500) and (USD 12,500) is provided. **Example:** if within a six-month period, BoP patients increased by (12%), the impact enterprise receives (USD 7,500) Total payments cannot exceed (USD 50,000)

SIINC Payments Example II (inclusive agricultural business):	
Improvement in income	**Indicator:** Number of harvesters who move to a higher earnings bracket as a result of their moss harvesting activities. **Payment system:** For every additional moss harvester entering a higher earning bracket, the impact enterprise is eligible to a SIINC payment between (USD 40) and (USD 70), with increases in lower-income brackets providing higher payments. **Example:** If within a year a harvester moves from bracket 2 to bracket 3, the impact enterprise is eligible for a payment of (USD 70) – if a harvester jumps two or more brackets (e.g. from 1 to 4) in one measurement period, the payment is doubled to (USD 140).

Main Advantages

- Aligns the interests of outcome payers (who pay for impact success), enterprises (who get paid premiums for additional outcomes) and investors (who indirectly benefit from investee's improved income situation).
- No need to set up a special purpose vehicle or any other kind of overlay structure (the SIINC agreement is separate from the investment contract).
- The outcome payer only pays for results (outcomes) beyond the projected growth curve of the impact enterprise.
- Eliminates potential frictions between impact and commercial concerns (can enable the enterprise to serve more rural, vulnerable, disadvantaged groups).
- Allows to target specific outcomes (e.g. women empowerment, rural area development, focus on bottom of the pyramid).
- Can be applied to different sectors, geographies and has no investment restrictions (i.e. there are no pre-defined investors, nor investment sizes or types – equity, debt, or mezzanine are all possible).

Main Challenges

- It is important to identify suitable outcomes to link payments to.
- Need for baseline assessment as a viable benchmark for incentives, for appropriate data gathering/generation methodologies and independent verification.
- Financial rewards have to be designed carefully on the basis of financial and impact modelling, in order to support the scaling strategy of the impact enterprise.
- The end of SIINC payment scheme (exit) has to be considered from the beginning so that the enterprise continues to generate the intended impact by realizing economies of scale (market-based exit) or by securing a public contract (public exit).

Case studies and additional resources about SIINC can be found here.

2.2 REIMBURSABLE AND CONVERTIBLE SIINC

Brief Description

Much like the standard Social Impact Incentives (SIINC) model, Reimbursable/ Convertible SIINC also reward impact enterprises with time-limited premium payments for achieving social impact. By linking public or philanthropic funding to pre-defined and proven social outcomes, high-impact enterprises can earn extra revenue, and scale both in terms of income and impact. This in turn, helps them to attract additional repayable investment – a pre-condition for receiving any kind of SIINC payments.

The main difference to traditional SIINC is that if an impact enterprise proves to be (commercially) successful beyond a certain level, SIINC payments will be partially or fully reimbursed or converted (e.g. into debt). While conditions can be freely negotiated, the most obvious scenario is to tie reimbursement/conversion to the commercial success of the enterprise, e.g. using pre-defined profitability or revenue triggers. This allows outcomes funders to "recycle" their resources and to generate additional impact. Reimbursable or Convertible SIINC are best suited for impact enterprises that are expected to be commercially strong and profitable in the mid-/long term, e.g. tech-based companies. Reimbursable/ Convertible SIINC are less viable for impact enterprises tilting towards slower growth and/or scale, as the burden of repayment or conversion could undo the progress made.

Emergency-Proof: This instrument is particularly relevant in difficult historical moment such as the Covid-19 crisis, when flexibility in repayments is critical to overcoming the severe social, financial, and economic challenges faced by enterprises.

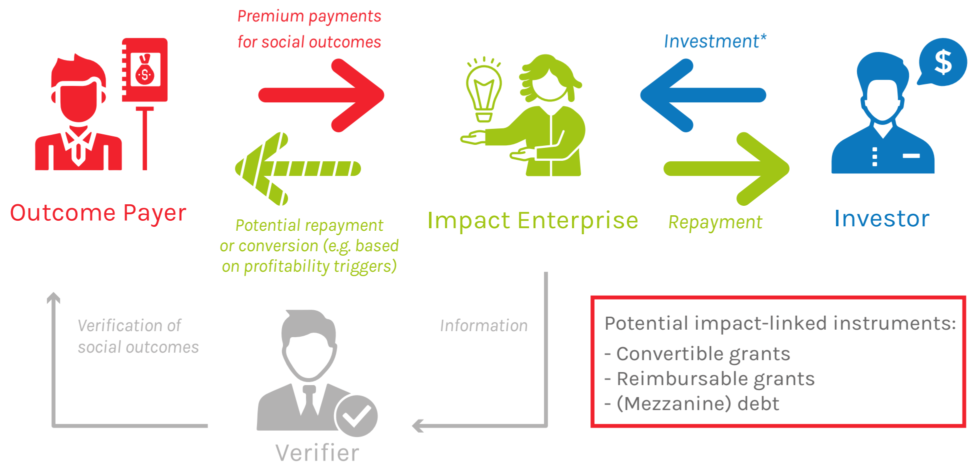


Figure 2.4 - "Reimbursable or Convertible SIINC", source: Roots of Impact.

Purpose/Fit	Enabling high-growth impact enterprises to attract investments and scale both in terms of income and impact (1). Improving the risk/return profile for investor (2). Allow outcome payer to "recycle" funding to generate additional impact (3).
Can replace	Patient equity, grants, catalytic capital, traditional SIINC, other blended finance instruments.
Risk/Return Profile	n/a
Enterprise Lifecyle	High-growth early and later stage companies.
Maturity	2-4 years + length of repayment / conversion process (TBD).

Defining Criteria

- **Reimbursability/Convertibility:** Funding provided by outcomes payer is partially or fully reimbursed/converted, e.g. based on pre-defined profitability or revenue triggers.
- **Financial reward for impact:** Ongoing payments to impact enterprises are linked to direct and measurable impact (aligns profitability with social impact).

- **Outcomes verification:** Independent verification of the results (outcomes).
- **Cap for financial reward:** Premiums are typically provided up to a capped amount.
- **Capital mobilisation:** Mobilisation of private investment (closing condition for any SIINC) creates leverage for provided catalytic funding.
- **Alignment of interests:** Impact enterprises and investors both carry the risk of underperformance for achieving outcomes, and both positively benefit from successful outcome achievements.

Example of Reimbursable/Convertible SIINC structures

- **Reimbursable SIINC:** The Company agrees to pay back the full amount of SIINC payments received in (3) annual instalments, once the annual profitability exceeds (USD 500,000).
- **Convertible SIINC:** Upon reaching (USD 2M) in revenue, (50%) of the SIINC payments are converted into debt. The Company agrees to repay the principal with an interest rate of (5%) p.a. within (3) years.
- Reimbursable or Convertible SIINC have not yet been implemented, however, recoverable grants are occasionally used to replace concessional debt.
- Structures should resemble the traditional SIINC model, with an additional agreement on the terms and conditions of the repayment / conversion of (part of) the catalytic funding, e.g. a pre-defined minimum commercial viability level, profitability trigger, timeline etc.

Examples of relevant terms (as formulated in a contract):	
Repayment	In the event the Company generates more than (USD 2,000,000) in Revenue, the Company shall be obligated to repay the full SIINC Obligation due under this financing in (3) equal instalments.
Conversion	The (50%) of SIINC payments shall be converted into debt in the event the Company generates more than (USD 1,000,000) in EBIT. The generated SIINC Loan shall accrue interest at a rate of (5%), compounding (quarterly), and the Company shall be obligated to (quarterly) repay principal and interest on a (fixed) schedule until the amounts paid have reached the Total SIINC Loan Obligation, in a period no longer than (3) years.

Main Advantages

- By tying reimbursement/conversion to the (commercial) success of the impact enterprise, the outcome payer receives (part of) its catalytic funding back and can "recycle" it to create additional impact.
- Eliminates potential frictions between impact and commercial concerns – particularly for tech-enabled enterprises in their early stages, when there is still a high level of flexibility about the strategy for scaling (e.g. can enable the enterprise to serve more rural, vulnerable, disadvantaged groups).
- Allows to target specific outcomes (e.g. women empowerment, rural area development, focus on BoP).
- The outcome payer only pays for results (outcomes) beyond the projected growth curve of the impact enterprise.
- No need to set up a special purpose vehicle or any other kind of overlay structure (the SIINC agreement is separate from the investment contract).
- Can be applied to different sectors, geographies and has no investment restrictions for the enterprise (i.e. there are no pre-defined investors, nor investment sizes or types - equity, debt, or mezzanine are all possible).

Main Challenges

- Reimbursement/conversion conditions need to be carefully selected, so as not to overburden the impact enterprise, risking undoing progress made or decreasing additionality.
- If not carefully structured, impact enterprises may end up having an incentive not to outperform so as not to trigger reimbursement/conversion of SIINC payments.
- Identifying suitable outcomes to link payments to is very important.
- Baseline assessment as a viable benchmark for incentives, appropriate data gathering/generation methodologies and independent verification are needed.
- Financial rewards have to be designed carefully on the basis of financial and impact modelling, in order to support the scaling strategy of the impact enterprise.
- The end of SIINC payment scheme (exit) and reimbursement/conversion has to be considered from the beginning so that the enterprise continues to generate the intended impact by realizing economies of scale (market-based exit) or by securing a public contract (public exit).

Case studies and additional resources about Reimbursable and Convertible SIINC can be found here.

2.3 IRMF (IMPACT-READY MATCHING FUND)

Brief Description

The Impact Ready Matching Fund (IRMF) is a non-repayable matching fund provided at the seed stage of an impact enterprise, with disbursements linked to milestones in the development of an impact management system. IRMF is a novel approach to supporting early stage impact enterprises, designed to be provided parallel to an investment by seed-stage (e.g. angel) investors. If milestones are met the IRMF matches the seed investment 1:1 and thus lowers the financing cost of the enterprise significantly. The model involves a donor/philanthropic entity committing to provide non-repayable funding to the enterprise against the achievement of milestones linked to the development and implementation of impact management system within the enterprise. The amount of the grant is tied to the amount of investment provided by a third-party private investor. The logic is to provide straightforward support in order to catalyse more early-stage investments while simultaneously incentivising enterprises to improve their impact management capacity. The achievement of the milestones is assessed by the provider of funding or an independent verifier.

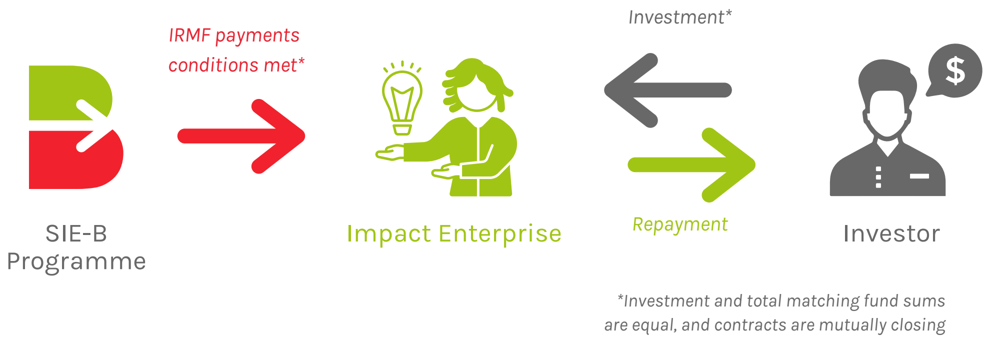


Figure 2.5 - "IRMF", source: Roots of Impact.

Purpose/Fit	Catalysing of angel investment round in order to support seed-stage impact enterprise with low cost capital. Supports creation of impact management systems by enterprises for later-stage access to impact investments.
Can replace	Grants (technical assistance, development grants).
Risk/Return Profile	n/a
Enterprise Lifecyle	Startup/seed (could conceivably be utilized for later stages, but investment sums might be prohibitive).
Maturity	Funds released over usually one year.

Defining Criteria

- **Milestone-based:** Funding is milestone-based, with disbursements released against advances in the development and implementation of an impact management system.
- **Impact management system:** The impact management system refers to structures and/or processes internal to the enterprise which enable the conceptualizing, tracking, managing and reporting of impact.
- **Capital mobilisation:** The IRMF is tied to an angel investment round which must involve the investment of repayable capital by a third-party investor.
- **Milestone verification:** Verification of the milestone achievement is conducted by the fund manager or an independent verifier, who check that the impact management system has been developed and implemented to a minimum standard.

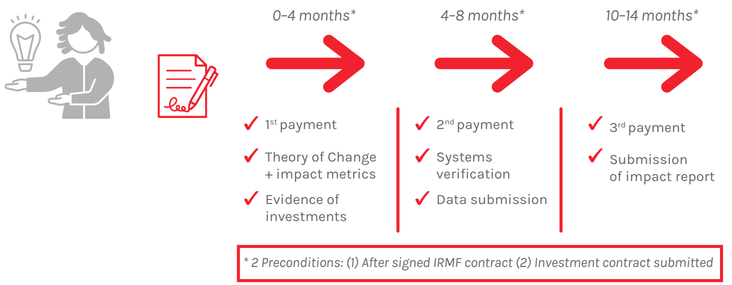
Interesting Variants and Options

- Instead of paying for several milestones the funding could be provided in one sum with achievement of the end result (i.e. the first impact report meeting pre-determined requirements).

Example of IRMF transactions

- n/a (first transactions planned in Bangladesh in 2020).

Examples of relevant terms (as formulated in a contract):	
Matching	The IRMF matches (1:1) repayable investment received by the enterprise in the (time period) up to an amount of (USD 100k).
Milestones-based disbursement	- **1st milestone/disbursement:** Initial 30% of the matching funding will be disbursed after the enterprise has developed a theory of change ("TOC") and a plan to track a set of impact indicators that address a key element of the organisations impact. - **2nd milestone/disbursement:** A further 30% of the payment will be disbursed upon submission of data and after verification that the agreed-upon metrics have been established and operationalised. - **3rd milestone/disbursement:** The final 40% will be disbursed after enterprise has submitted an impact report meeting minimum requirements.



Main Advantages

- Straightforward means of catalysing early-stage investment rounds.
- Builds pipeline for later-stage impact investors.
- Can put enterprises on a strong impact trajectory and institutionalise an impact focus from an early stage (relevant also for access to impact investment).
- Helps promote impact management throughout the eco-system.
- Unlike a simple matching grant, an IRMF directly links payments to milestones/results.
- Unlike technical assistance grants, an IRMF has a direct link to an investment round while at the same time supporting the enterprise to build up impact management capacity.

Main Challenges

- Ensuring cost efficiency (compared to a simple matching grant).
- Greater administration requirements than a simple matching grant.
- Choosing most suitable enterprises with strong potential for impact and scale.
- Ensuring that the impact focus and systems remain in place after the IRMF funding has been fully disbursed.

A hypothetical case study and additional resources about IRMF can be found here.

OTHER IMPACT-LINKED FINANCE INSTRUMENTS

3

The following section examines two financing instruments for impact enterprises which link financial rewards to the achievements of positive social outcomes - thus, effectively aligning positive impact with the economy viability of the impact enterprise.

Figure 3.1 - "Other Impact-Linked Finance Instruments", source: Roots of Impact.

3.1 IMPACT-LINKED LOAN

Brief Description

An Impact-Linked Loan is similar to a traditional loan, with the main exception that interest rates (potentially even repayment obligations) are tied to borrowers' achievement of pre-defined and independently verified social outcomes. The enterprise receives "better terms for better impact". The higher the impact achieved by the impact enterprise, the lower the interest rate to be paid. In specific scenarios and contexts (e.g. particularly difficult market environment or crisis) additional loan forgiveness can be agreed upon for achieving additional pre-defined outcomes.

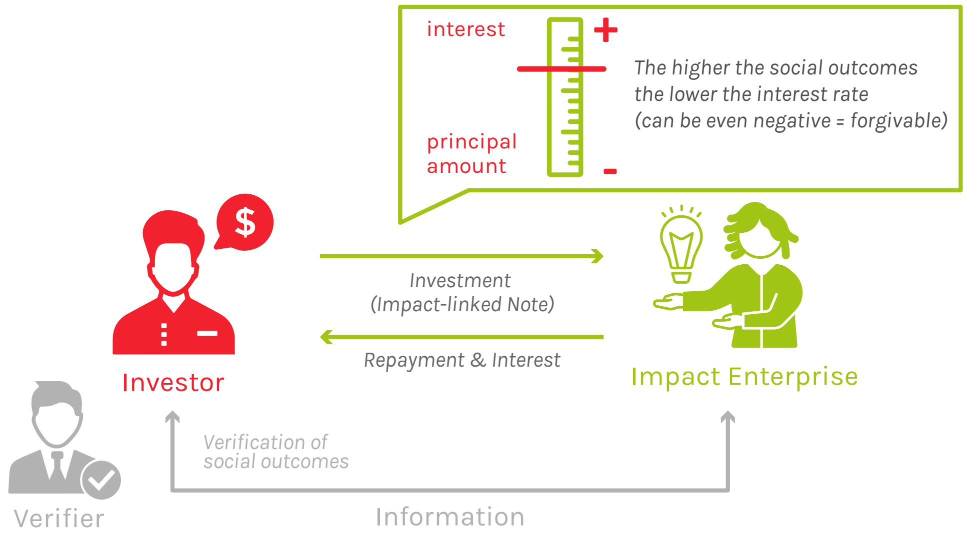


Figure 3.2 – "Impact-Linked Loan", source: Roots of Impact.

In other words, impact enterprises are encouraged to maximise their social outcomes, with financial rewards ranging from discounted interest payments to partial or even complete forgiveness of the loan repayment.

Overall, providers of Impact-Linked Loans are primarily motivated by impact (catalytic funders/impact-first investors), as they are expected to take lower returns due to the more favourable terms for the enterprise. However, there is the option for public or philanthropic funders to provide investors with a compensation to make up for the lower return (blended finance; see "Interesting variants and options" below).

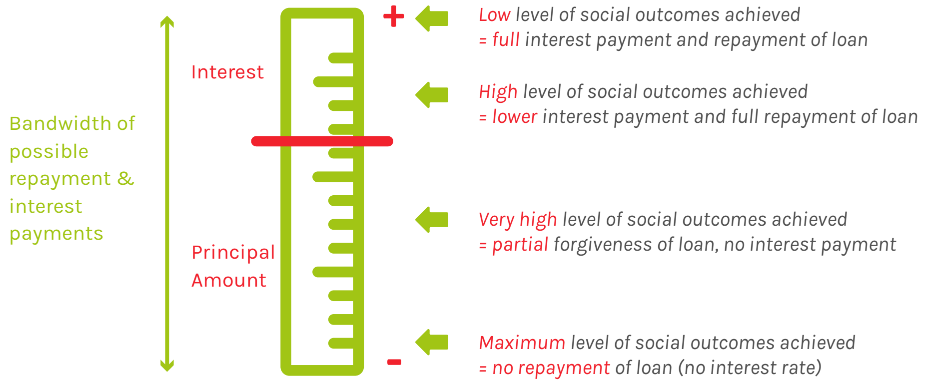


Figure 3.3 – "Interest, Principal and Impact created" source: Roots of Impact.

Purpose/Fit	High-impact enterprises gain access to loans with (highly) favourable terms and are incentivised to maximise their impact.
Can replace	Traditional debt, grants, and (other) blended finance instruments
Risk/Return Profile	n/a
Enterprise Lifecyle	All stages
Maturity	Various (but needs time to create positive outcomes)

Defining Criteria

- **Interest rate linked to impact:** Interest rate (and potentially repayment) is linked to direct and measurable impact, and follow the concept of better terms for better impact.

- **Financial reward for impact:** Rewards range from discounted interest payments to partial or even complete forgiveness of the loan repayment.

- **Incentive for impact:** Strong incentives for impact enterprises to outperform on positive impact.

- **Impact verification:** Independent verification of the achievement of pre-defined outcomes.

- **Term maturity:** Impact-Linked Notes have usually longer tenors (~3-5 years) than traditional loans.

- **Impact-Return trade-off:** Investors are primarily motivated by impact (catalytic funders/impact-first investors) as they are expected to take lower returns, unless they are compensated by an outcome funder.

Interesting Variants and Options

- **Impact-Linked Loans with compensation by public or philanthropic funder:**
  - Public or philanthropic funders can provide investors with a compensation to make up for their lower returns resulting from more favourable terms for the enterprise (blended finance).
  - In addition to compensating for lower returns, they can provide capital in form of grants, which can be used to reduce investment risks for investors, e.g. by (partially) covering first losses.
  - Parts of the grants provided to impact investors to compensate for the lower return can be used by the lender for zero-interest loans. The combination of non-interest-bearing capital from donors with the impact investors' interest-bearing capital, lowers the total interest rate to be paid by the impact enterprise.

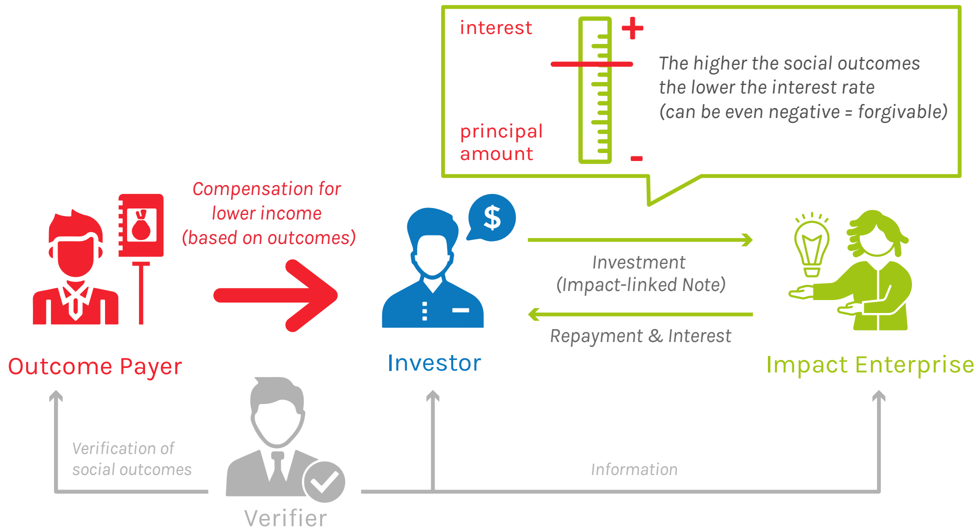


Figure 3.4 - "Impact-Linked Loan with compensation by public or philanthropic funder", source: Roots of Impact.

- **Impact-Linked Convertible Loans:**
  - Once a pre-defined trigger (e.g. qualified equity round) is reached, the loan (fully or partially) converts into equity.
  - The discount applied depends on the impact performance – the higher the impact the lower the discount.

- **Impact-Linked Revenue-Share Agreements:**
  - Within a pre-defined range (regular rule-based adjustment), the level of revenue share is linked to the social enterprises' impact performance – the higher the social outcomes, the lower the revenue share or the total amount to be paid back (e.g. reducing the multiple).

Example of Impact-Linked Loans structures:

- Impact-Linked Loans: The Impact Investment Group provided a USD 407,000 loan to the impact enterprise Xceptional, with the clause that the more social impact the job placement firm working with people with autism delivers, the more their overall repayment is reduced. As target outcomes they look at the number of people placed in high-quality roles, their job satisfaction and happiness. Other key terms included a grace period at the start of the loan period, when no cash repayments are due.

- Impact-Linked Loans with compensation by public funder: The "impact-first" investor Open Road Impact Fund with support from the Swiss Agency for Development and Cooperation (SDC), provides emergency loans (generally <USD 100,000) to impact enterprises in Latin America and the Caribbean responding to the Covid-19 crises. SDC has made grants available, used for zero-interest loans, lowering total interest to be paid by impact enterprises and partly covering first losses. If not used to cover losses, and if certain impact targets are met, impact enterprises need to pay back only part of the capital.

Examples of relevant terms (as formulated in a contract):	
Loan amount	The Financing Amount is (USD 300,000) in aggregate principal amount of Impact-Linked Loan.
Impact performance index:	• Pre-agreed weighting of up to (three) pre-defined impact KPIs form an index for impact performance. • Index ranges from (0) to (>=120) with reduction of interest rate (total reduction at maturity retrospectively) ranging from (0%) to (3.2%).
Interest rate	• The Impact-Linked Loan will accrue interest at a rate (per annum) of maximum (6%). • Maximum interest rate p.a.: (6%) • Minimum interest rate p.a.: (-10%) (partly debt forgiveness) • Example: if the impact performance equals to (110) (indexed), the p.a. interest rate is reduced by (2.9%)

Main Advantages

- High-impact enterprises have access to concessional loans and some of the (re)payment burden is lifted according to the impact they create.
- Impact enterprises are incentivised to increase and outperform on their impact.
- Avoid mission drifts, allowing impact enterprises to scale without having to compromise on their social values and outcomes.
- More favourable loan terms can unlock more resources, i.e. leverage private sector capital.
- Meets the needs of high-impact enterprises and aligns investor and investee's interests.

Main Challenges

- There are few investors who are willing (and able due to fiduciary duties) to sacrifice financial returns for higher levels of impact.
- Public and philanthropic funders are not used to compensate private investors for the losses that come along with more concessional terms.
- The financial rewards must be carefully determined in order to find the right balance between (a) appropriate incentives for impact enterprises to keep their focus on impact, and (b) not providing an unnecessary level of subsidies.
- Internal as well as external regulations.

Case studies and additional resources about Impact-Linked Loan can be found here.

3.2 IMPACT-LINKED CONVERTIBLE NOTE

Brief Description

While largely in line with Impact-Linked Loans (see page 41), the main distinguishing feature of Impact-Linked Convertible Loans is that upon reaching of a pre-determined event (e.g. qualified equity round) the loan is (partially or fully) converted into equity. Terms of the loan are similarly tied to borrower's achievement of pre-defined social outcomes, with the same concept of "better terms for better impact" applying. As such, the discount rate for instance, depends on borrower's impact performance up until the triggering event. The higher the impact achieved by the impact enterprise, the lower the discount. Same can hold for the interest rate due upon conversion. In specific scenarios and contexts, achieving very high social outcomes can possibly even translate into negative interest rate, i.e. debt forgiveness. Overall, providers of Impact-Linked (Convertible) Loans are primarily motivated by impact (catalytic funders/ impact-first investors), as they are expected to take lower returns due to the more favourable terms for the enterprise. However, there is the option for public or philanthropic funders to provide investors with a compensation to make up for their lower return (blended finance).

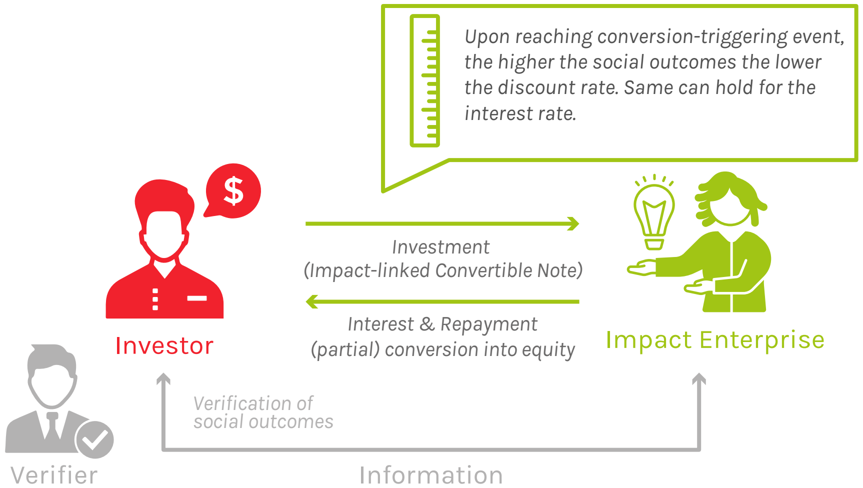


Figure 3.5 - "Impact-Linked Convertible Loan" source: Roots of Impact.

Purpose/Fit	High-impact enterprises gain access to convertible loans with (highly) favourable terms, and are incentivised to maximise their impact
Can replace	Traditional loans, Impact-Linked Loans, Convertible Loans and (other) blended finance instruments
Risk/Return Profile	n/a
Enterprise Lifecyle	Seed stage
Maturity	Various (but needs time to create positive outcomes)

Defining Criteria

- **Convertibility:** A pre-defined triggering event (e.g. an equity funding round) leads to full or partial conversion of the loan into equity.
- **Discount rate:** It allows the investor to convert to equity at a discount price during a later round of financing. The discount factor is calculated as follows: [100 – discount rate]%.
- **Link to Impact:** Discount and/or interest rates are linked to direct and measurable impact performance and follow the concept of "better terms for better impact". This creates strong incentives for impact enterprises to outperform on positive impact.
- **Impact verification:** Independent verification of the achievement of pre-defined outcomes.

Example of Impact-Linked Convertible Loans structures

- To date, this innovation has not been implemented yet.
- Structures of the Impact-Linked Loan (page 41) and the Convertible Note (page 21) can be used as a broad guideline.

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Examples of relevant terms (as formulated in a contract):	
Loan amount	The Financing Amount is (USD 300,000) in aggregate principal amount of Impact-Linked Convertible Note.
Interest rate	• The Impact-Linked Loan will accrue interest at a rate (per annum) of maximum (6%). • Maximum interest rate p.a.: (6%). • Minimum interest rate p.a.: (-10%) (partly debt forgiveness). • Example: if the impact performance equals to (110) (indexed), interest rate p.a. is reduced by (2.9%).
Impact performance index	• Pre-agreed weighting of up to (three) pre-defined impact KPIs form an index for impact performance. • Index ranges from (0) to (>=120) with reduction of interest rate (total reduction at maturity retrospectively) ranging from (0%) to (3.2%).
Discount	• Actual discount at conversion linked to impact performance. • Maximum discount rate: (20%). • Minimum discount rate: (0%). • Example: if indexed impact performance is (40), the discount rate reduction amounts to (1.2%).

Main Advantages

- Convertible structure spurs interest among a wider array of impact investors.
- High-impact enterprises have access to concessional loans with impact trigger and quick funding possibilities.
- Some of the (re)payment burden is lifted according to the impact created.
- Impact enterprises are incentivised to outperform on their impact.
- More favourable loan terms can unlock more resources, i.e. leverage private sector capital.

Main Challenges

- There are few investors who are willing (and able due to fiduciary duties) to sacrifice financial return for higher levels of impact (public or philanthropic funders can provide investors with a compensation to make up for the lower return).
- Rewards for the impact enterprise must be carefully determined in order to find the right balance between (a) appropriate incentives to keep the focus on impact, and (b) not providing unnecessary levels of subsidies.
- Internal as well as external regulations.

Case studies and additional resources about Impact-Linked Convertible Note can be found here.

Other Catalytic Funding Instruments – Attracting Additional Investment

4

The following section examines two financing instruments for impact enterprises which enable to improve the risk profile of an enterprise, thus helping to mobilise greater amounts of capital and encouraging the flow of additional funding (blended finance).

Figure 4.1 – "Other Catalytic Funding Instruments to Attract Additional Investment", source: Roots of Impact.

4.1 (PARTIAL) GUARANTEE

Brief Description

A (partial) guarantee [28] is the commitment of a guarantor to back up and provide repayment in case of default or non-performance of the enterprise. A (partial) guarantee can have an important role for impact enterprises as it represents a mechanism to increase the security and facilitate the mobilisation of private capital from investors, thus promoting financial access. In fact, the guarantee acts as a sort of insurance, allowing the impact enterprise to lower the relative risk [29] of the organisation, increase access to lending, and obtain exposure to a wider source of funding with improved financial terms and conditions. A partial guarantee does cover only part of the risk (e.g. 80% of a loan) in order to ensure alignment of interest between the guarantor and the investor. A partial guarantee can also cover a portfolio of investments insofar that it provides partially repayment in case of default from any investment in the portfolio (e.g. 80% from any investment) up to a pre-defined cap of the portfolio (e.g. 30% of the portfolio).

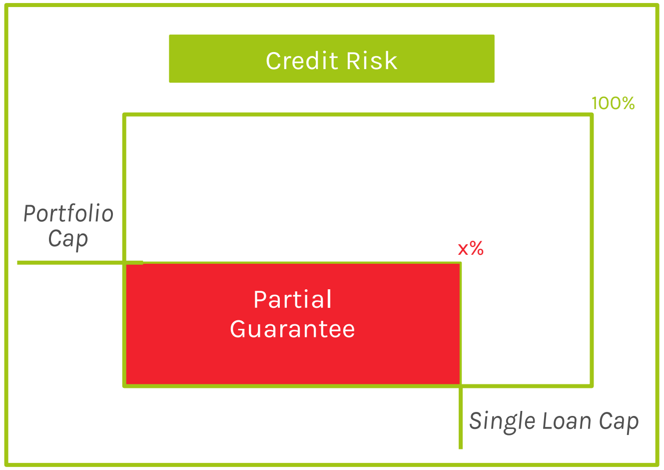

Figure 4.2 - "Partial Guarantees", source: Roots of Impact.

28 A guarantee is considered as partial if the value of the guarantee is less than 100%

29 A guarantee is usually structured to cover credit risk, but other risk categories could be considered (e.g. political risk)

Emergency-Proof: This instrument is particularly relevant in difficult historical moment such as the Covid-19 crisis, when flexibility in repayments is critical to overcoming the severe social, financial, and economic challenges faced by enterprises.

Purpose/Fit	Enabling the impact enterprise to access private risk capital
Can replace	Grants, subordinated loans, and other blended finance instruments
Risk/Return Profile	n/a
Enterprise Lifecyle	All stages
Maturity	Linked to the maturity of an outstanding loan or other financial obligations

Defining Criteria

- **Guarantee level:** It represents the percentage that the guarantor commits to cover in case of default or non-performance.
- **Guarantor:** It is the agent who agrees to be held responsible for the repayment of the guaranteed portion of the financial debt if the receiver defaults. The main provider of guarantees are multilateral agencies or development finance institutions.
- **Front-end fee:** It represents the one-time fee that the borrower has to pay on the guaranteed amount. It is usually required to cover due diligence, processing of the guarantee and other potential up-front costs.
- **Guarantee fee:** It represents a per annum fee on the disbursed and/or outstanding guarantee exposure. It is required in order to cover the guarantor exposure on the guaranteed amount.
- **Commitment fee:** It represents the fee required to be paid on the amount requested, yet not disbursed.

Interesting Variants and Options

- The guarantee or partial guarantee may be structured to partially cover principal repayments and interest, or only a part of the principal repayment, or only the interest payments.
- Guarantees are usually applied to infrastructure and financial services, but other sectors could be considered.
- Linking financial rewards to the achievement of impact, for example increasing the guarantee level or reducing the guarantee fee – see "Examples of relevant terms" and "Examples of partial guarantee structures" below.

Example of relevant terms (as formulated in a contract)

- **Loan Guarantee:** A partial guarantee could be structured to cover the principal amortisation and or interest payments in the lifetime of a loan. The guarantor for instance may take on the credit risk of the borrower for both interest and principal repayments, and in case of a debt service default [30], repay (based on the percentage of the guarantee) the outstanding amount at the time of default.
- **Bullet Loan Guarantee:** In the case of a loan with a bullet maturity[31], a partial guarantee could be structured to repay back a predefined percentage of the debt amount at maturity.
- **Impact-Linked Guarantee:** The amount of investment covered by the guarantee is directly related to the expected impact performance of the enterprise and will be adjusted at pre-defined future dates based on verified outcomes. Thus, the guarantee can be used for targeting and catalysing specific outcomes, and a stronger impact performance will then translate into higher guarantee amounts.
- **Impact-Linked Guarantee on a fund level:** The amount of investment covered is directly related to the impact performance of a portfolio of companies rather than one single enterprise.

30 By a debt service default, it is intended the situation when a borrower misses a schedule payment.

31 A bullet maturity refers to repayment of the whole amount borrowed (face value) at maturity, as opposed to a traditional amortised repayment schedule. Sometimes the bullet maturity amount can also be comprehensive of interests.

Examples of relevant terms (as formulated in a contract):	
Guarantee level	• The Guarantee issued by the Guarantor for the benefit of the Company has a Guarantee Rate of (60%) on the Borrowed Amount. The Guarantee issued by the Guarantor has an uncapped, unconditional and irrevocable financial guarantee in respect of each Eligible Transaction in a set Portfolio up to a Guarantee Rate of (50%) on the Total Invested Capital
Guarantee fee	The Guarantee Fee is (130bps) per annum. The Company shall pay the Guarantee Fee Amount (quarterly) in (arrears) on the aggregated outstanding amount at the end of the calendar quarter.
Optional: Link to Impact Performance	• The partial guarantee of (50%) will be increased by (5%) for each (1,000 units of impact) achieved until reaching full guarantee (100%) in order to facilitate further rounds of funding. • The fee charged for the guarantee will be decreased by (0.15%) for each (1,000 units of impact) achieved until reaching (0.00%)

Main Advantages

- Partial guarantees can help the impact enterprise to obtain more convenient financial terms and conditions as well as to lower the cost of capital.
- They can help the impact enterprise to mobilise additional and more diverse private capital by catalysing more risk-averse sources.
- They can be applied throughout the life of an impact enterprise.
- Investors as well as the markets are familiar with the instrument.

Main Challenges

- They can create moral hazard[32] and disincentivise the investor to carry out a proper due diligence (shall be avoided by providing only partial guarantees where the investor carries part of the risk as well).
- Lack to directly account for impact at the enterprise level if not linked to the achievement of impact.
- The impact enterprise may find itself in the position to use part of the additional capital raised to pay for the fees charged by the guarantor, thus slightly offsetting the overall benefits.

Case studies and additional resources about (Partial) Guarantee can be found here.

32 It is defined as the tendency of deliberately adopting more risk-taking behaviours. It usually happens when a person bears only partially the costs arising from taking greater risk, and they are thus incentivised by the allure of the potential benefits.

4.2 SUBORDINATED LOANS (ACTING AS CATALYTIC FIRST-LOSS CAPITAL WITH EQUITY)

Brief Description

A subordinated loan is a rather simple catalytic instrument that can help to channel capitals towards impact enterprises. It can be incorporated into a capital structure or a hybrid of debt and equity [33] that ranks below senior debt but above common shares in the liquidity order of priority. The liquidity order determines who gets paid first in case of bankruptcy, and it follows a waterfall payment system, where senior lenders are the first to receive payments followed by the subordinated lenders if and only if the senior creditors have been fully paid back.

A subordinated loan together with the equity of an enterprise serves the role of the so called catalytic first-loss capital. The catalytic first-loss capital is a bundle of instruments that enables to improve the risk profile of an impact enterprise, thus mobilising greater amounts of capital towards addressing social challenges, and encouraging the flow of additional funding, in particular in the form of Senior Unsecured Loan and Senior Secured Loan.

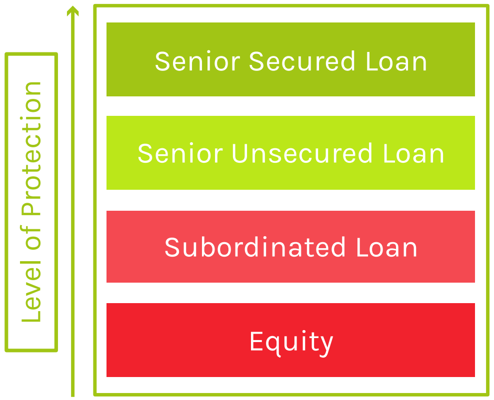

Figure 4.3 - "Subordinated Loan", source: Roots of Impact.

33 Usually also known as mezzanine financing in the venture capital realm

Purpose/Fit	Enabling the impact enterprise to access private capital
Can replace	Grants, equity, guarantees
Risk/Return Profile	Depends on individual case
Enterprise Lifecyle	All stages
Maturity	Based on the funding need of an impact enterprise

Defining Criteria

- **Priority:** It states the position in the distribution of payments in the event of liquidation or winding up of the company. A subordinated loan entitles the holder to receive payment prior to the shareholders but subsequent to all the other more senior creditors. In case of insufficient funds to pay the amount owned to subordinated loan holders in full, a pro rata percentage of the remaining assets or proceeds should be distributed.
- **Catalytic effect:** The catalytic nature of the instrument is of utmost importance. In fact, the final goal of the instrument shall be to cause the participation of investors who would not have participated, and mobilise volume of capital that otherwise would not have been obtained ("financial additionality").

Interesting Variants and Options

- An equity co-investment could be incorporated with a subordinated debt to reduce even more of the risk associated with investing by other capital providers. In fact, equity is the most subordinate form of capital constituting the first layer to absorb losses.
- The subordination can also be applied to the equity investment. By investing in the most junior form of equity, usually known as class C-shares, an investor can create a further layer to protect the other capital providers.
- The subordination can be applied both on a transactional level[34] and on a fund level. A fund level subordination implies that an investor is providing

34 Investing in subordinated debt of a specific enterprise

funds for the first-loss tranches in a structured fund, thus enabling the fund to mobilise larger investment volumes.

- Linking financial rewards to the achievement of impact, for example reducing the interest rate – see "Examples of relevant terms".

Example of relevant terms (as formulated in a contract)

- Mezzanine Debt enhanced by an equity kicker usually in the form of a warrant[35], it is a subordinated loan with the right to receive detachable and freely transferable warrants or other securities which provide the right to acquire a specific percentage of the fully diluted stock or company value at closing.

Examples of relevant terms (as formulated in a contract):	
Priority	In the event of liquidation or winding up of the company, the holder of the Subordinated Loan will be entitled to receive the outstanding amount prior to any payments or distribution to the equity holders of the company, but subordinate to other debt obligations. In the event of the Company's assets or proceeds from the sale thereof do not fully repay the outstanding amount, each holder of the Subordinated Loan shall receive its pro rata percentage of such remaining assets or proceeds thereof. The Subordinated Loan is unsecured and subordinated to all indebtedness of (company name), other than indebtedness expressed to be pari passu with or subordinated to the Subordinated Loan. On a liquidation of (company name), the Subordinated Loan ranks equally with all the other unsecured, subordinated obligation of the company. The Subordinated Loan ranks behind the Company's bank debt, senior bonds, and any amounts owing to unsubordinated general and trade creditors, as well as indebtedness preferred by law and secured indebtedness.
Optional: Link to Impact Performance	If the impact performance equals to (impact performance index), the interest rate is reduced by (2.0%). The pre-agreed interest rate of (8%) is reduced by (0.125%) for every (1,000 units of social outcomes) achieved by the company up to an interest rate of (2.0%).

Main Advantages

- They help the impact enterprise to attract more risk-averse investors, and obtain more convenient financial terms and conditions.
- It allows an impact enterprise to access additional funding when its access to senior debt (e.g. bank loans) or other secure way of funding are unavailable or unwanted.
- Flexible form of long-term capital.

Main Challenges

- If the goal of the capital provider is merely to provide a catalytic instrument, then the use of guarantees could prove to be more appealing as they don't require capital to be injected in the company.
- Possible perceived lack of impact accountability from the capital provider. An investor may prefer to observe more tangible impact being produced as a result of the investment, rather than the mere enhancement of the risk and credit profile of a company. While it is true that a subordinated loan helps the impact enterprise to mobilise greater volumes of capital and therefore helps a company to scale, the impact produced has an indirect cause effect relationship.

Case studies and additional resources about Subordinated Loans and Catalytic First-Loss Capital can be found here.

35 It is a financial security that gives the right to the holder to buy an underlying stock at predefined terms. The equity kicker can also come in the form of a bonus payment or other equity participation instruments

5

RESULTS-BASED FINANCE INSTRUMENTS FOR NON-PROFIT ORGANISATIONS

The following section examines two financing instruments which link financial rewards to the achievement of specific results for non-profit organisations – thus providing and encouraging a more efficient and effective use of public or philanthropic finance.

Figure 5.1 – "Result-Based Finance", source: Roots of Impact.

5.1 SOCIAL/DEVELOPMENT IMPACT BOND

Brief Description

A Social or Development Impact Bond (SIB or DIB) is a pay-for-results funding model involving multiple parties. It is designed to enable non-profit interventions (typically encouraged by public actors) to attract private investment in order to pre-finance the activities needed to generate a defined set of impact outcomes (outcome targets). Private investors provide the up-front capital. The impact bond reimburses the investors for their capital with a pre-defined return in case the outcomes targets are achieved. The transaction may be structured with a Special Purpose Vehicle (SPV) which acts as a contract partner for all actors involved. In this case the SPV takes on the private capital from the investors and contracts one or more service providers who are charged with actually generating the outcomes. The service providers are usually NGOs. There is typically an independent organisation involved for verification of the impact outcomes.

An impact bond is not a bond in the traditional sense of the word, since the repayment and the return are dependent on the achievement of desired outcomes. In case the outcomes target is not met, the investors typically receive neither a return nor the (full) repayment of the principal.

Purpose/Fit	De-risk the testing and roll-out of innovative service delivery models by non-profit organisations, attracting private investment for the pre-financing of non-profit programmes
Can replace	Grants, public contracts
Risk/Return Profile	Dependent on the risk to achieve the pre-defined outcome target
Enterprise Lifecyle	No enterprise, but an (established) non-profit organisation with existing track record for achieving impact outcomes
Maturity	Linked to the length of the intervention, but usually around 3 years

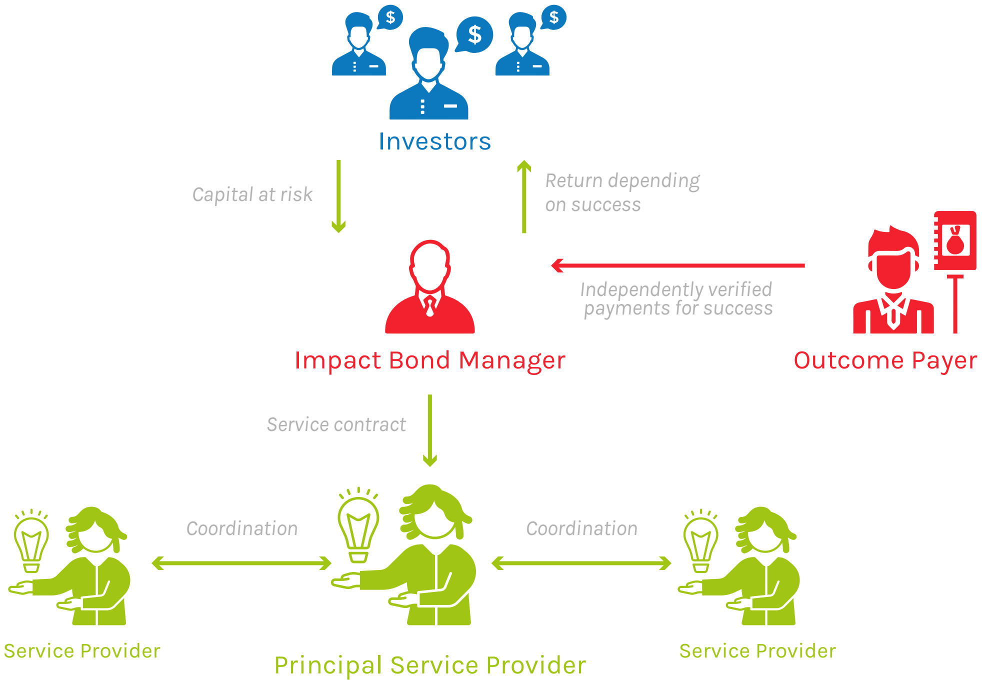

Figure 5.2 - "Understanding Social Impact Bonds", source: OECD.

Defining Criteria

- **Outcomes-based:** Repayment and return for the investor are tied to the achievement of outcomes (as opposed to activities or outputs).
- **Shift of risk to investors:** Investors, but not the service providers, carry the risk of non-achievement of outcome targets.
- **Specific scope:** Often focused on prevention measures and public cost savings.
- **Impact verification:** Independent verification of the outcomes.

Involved parties

- Outcome payer is the entity which places the ‘pre-order’ on the outcomes to be generated. This is usually a local government entity (Social Impact Bond/SIB) or an international development funder (Development Impact Bond/DIB); philanthropic foundations can also engage as outcome payers (though have typically engaged as the investor up to now).

- Investors provide private capital which is used to pre-finance the activities of the non-profits (service providers) and gets repaid with returns in the case of success.

- Service providers are generally NGOs who enter into a contractual agreement with the impact bond and agree to deliver certain outcomes against pre-financing.

- Fund manager (or Transaction manager) as a central intermediary engages in the process of brokering and managing the impact bond transaction; in case an SPV is used, the fund manager is the one to manage it.

- Impact verifier is the independent organisation in charge of evaluating the level of target achievement of outcomes.

- There can be a performance manager and/or advisor involved in supporting the service provider to achieve the impact outcomes and in providing a source of information and scrutiny to investors and the outcome payers.

Interesting Variants and Options

- In case of no need for pre-financing: a direct performance-based contract with ongoing results-based payments for outcomes achieved between the outcome payer and the service provider can replace the impact bond structure, thereby removing the SPV and reducing the complexity of the transaction (no need for raising private investment).

- In case of limited need for pre-financing: a direct performance-based contract with an up-front payment (i.e. 30% of total funding) and ongoing results-based payments for outcomes achieved between the outcome payer and the service provider can replace the impact bond structure, thereby removing the SPV and reducing the complexity of the transaction (no need for raising private investment).

- The risk for the investor can be partly reduced by a guarantee or first-loss capital provided by another public or philanthropic funder.

- Staggered outcome targets can be defined so that repayment and return for investors is not "all or nothing".

- Bonus payments for the service provider can be agreed upon to increase the performance orientation (and return participation) of the service provider.

Example of Impact Bond structures

- Social Impact Bond: The pioneering example for a Social Impact Bond (SIB) is the Peterborough bond in the United Kingdom (HMP Peterborough). In this example, a set of service providers were funded to decrease the reoffending rates among ex-convicts being released from Peterborough prison. The bond did meet its targets and the investors were repaid. The bond was not continued.

- Development Impact Bond: An example for a Development Impact Bond (DIB) in the education sector is the ‘Quality Education India Development Impact Bond’. In this case the objectives relate to educational enrolment and achievement (learning outcomes) among girls in selected regions. The impact bond currently operating is an expansion of an initial pilot DIB called ‘Educate Girls’.

Examples of relevant terms (as formulated in a contract):	
Priority	Definition: Student enrolment defined by the number of out-of-school girls (between age 7 and 14) enrolled in school by the end of the third year. Outcome target: 79% of all eligible out-of-school girls.
Learning outcome improvement	Definition: Learning outcome improvement: standard deviation[36] as a difference from the comparison group performance. Maximum Payment: (USD 71) Outcome target: (0.4)
Investor Return	Repayment of investment plus (15%) p.a. in case of full target achievement (outcomes). Repayment of investment plus (10%) p.a. in case of target achievement (outcomes) of minimum 90%.

Main Advantages[37]

- Impact bonds can encourage innovation and tackle difficult social problems (including prevention).
- The public sector (funder) only has to pay for results (i.e. effective services); the third-party investor bears all the risk of services potentially being ineffective.
- The impact bond approach embeds the ongoing evaluation of programme impacts into programme operations, accelerating the rate of learning about which approaches work, and which do not.
- Enables collaboration between multiple stakeholders.

36 Standard points of variation around the mean

37 Source: "Building the tools for public services to secure better outcomes: Collaboration, Prevention, Innovation", Carter, E., Fitzgerald, C., Dixon, R., Hameed, T., Airoldi, M., The Government Outcomes Lab (2018);"Putting the front line first: smarter government", Cabinet Office (2009): "Towards a New Social Economy: Blended value creation through Social Impact Bonds", Social Finance (2010)

Main Challenges[38]

- Impact Bonds are often complex and time-sensitive instruments that require adaptability from the stakeholders engaged in them.
- Impact Bonds have been proven to be costly instruments so far.
- Ensuring continuity of social service delivery for vulnerable groups and citizens is indispensable.
- Stimulating social innovation can be a significant benefit but is not guaranteed.
- More evidence and rigorous evaluations (including a "theory of change" for using Impact Bonds) are needed.

Case studies and additional resources about Social/Development Impact Bond can be found here.

38 Source: "Understanding Social Impact Bonds", OECD (2016)

5.2 PERFORMANCE-BASED CONTRACT

Brief Description

A Performance-Based Contract (PBC) is a pay-for-results funding model between public or philanthropic donor(s) and one or more service provider(s)/ implementer(s). With the objective to enhance the targeting and effectiveness of interventions, payments are (partly) linked to the achievement of pre-defined and independently verified targets – historically mostly outputs (e.g. medical treatments performed), but increasingly also outcomes (e.g. treatment results). A shift from outputs to outcomes is in particular valuable to ensure that funding is used effectively, and service providers are incentivised to create the desired effects for the end beneficiaries.

While a "pure" PBC is possible, e.g. in cases when implementers have enough own funds to pre-finance the programme (figure 9.3), most PBCs feature a hybrid structure (figure 9.4), with part of the funding paid upfront (e.g. on a input/activities-basis) and the rest based on results. Providing implementers – often NGOs with a limited budget – with an upfront payment allows them to increase their resources and have greater flexibility on how to reach the pre-defined targets. The proportion of upfront and performance-based payments is variable.

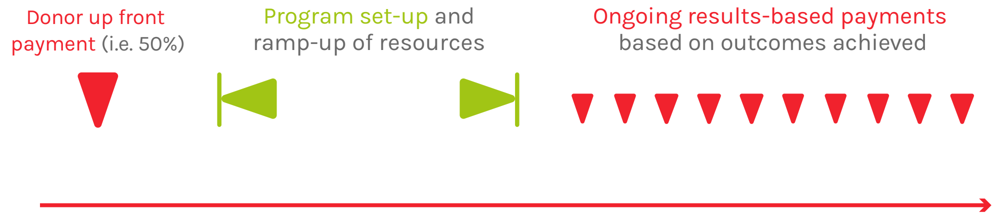

Figure 5.3 – "Pure PBC", source: Roots of Impact.

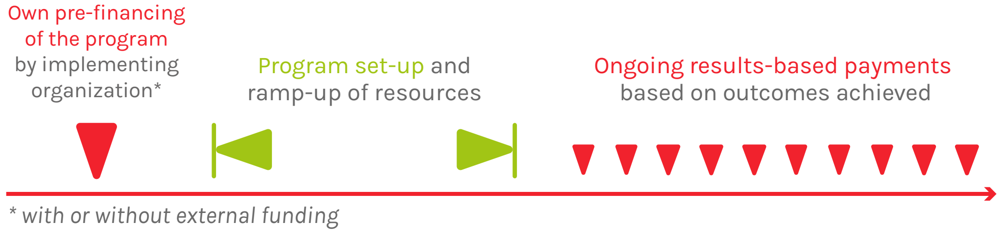

Figure 5.4 – "Hybrid PBC", source: Roots of Impact.

The underlying aim for PBCs is to empower innovative service provision and trigger higher performance. Strong probability of success (e.g. proven track record, credible data, clear and common objectives, solid monitoring system etc.) are needed to provide the necessary confidence for all stakeholders to implement a Performance-Based Contract. Especially when outcome-focused, PBCs represent a valid alternative to social/development impact bonds (see page 53). Given no private investment is involved, PBCs do not require a special purpose vehicle (SPV), thus decreasing the costliness and complexity of transactions. A PBC can also be used by the service provider to raise external, repayable finance in order to pre-finance the activities. By doing this, the structure becomes quite similar to an impact bond with the exception that the risk of underperformance lies with the service provider.

Purpose/Fit	Enable and incentivise social service providers (typically non-profit organisations) to implement effective solutions and outperform on impact, thus ensuring successful deployment of donors' funds
Can replace	Social/Development Impact Bonds, grants, public contracts
Risk/Return Profile	n/a (typically no investor involved)
Enterprise Lifecyle	All stages (typically non-profit organisations)
Maturity	Linked to the length of the intervention

Defining Criteria

- **Output or outcome-based:** Ongoing results-based payments tied to the achievement of results (outputs or outcomes).
- **Direct incentivisation:** Incentivisation of the value creator/ outperformance trigger.
- **Flexibility:** Pre-defined metrics and verification methods, but flexibility on approach.
- **Optional upfront funding:** Potential upfront funding to service providers so as to increase their resources and flexibility.
- **Risk transfer to implementer:** Transfer of risk to implementing organisation (depending on proportion of upfront and performance-based payments).
- **Output or outcome verification:** Outputs or outcomes are independently verified.

Interesting Variants and Options

- **Output-Based Aid (OBA):** This is a PBC between donors and public/private providers, with the latter being provided with subsidies dependent on the achievement of certain pre-agreed results. OBAs complement or replace users' contributions. They are used to improve access to and delivery of basic infrastructure and social services (e.g. water and sanitation services) to the poor.
- **Performance-Based Financing (PBF):** This is a PBC typically used to fund health providers on a fee-for-service basis, with payments being conditional on the achievement of pre-defined targets that assure the quality of the service.
- **Prize-Based Challenge:** This is a form of PBC where an open-bid competition rewards (financially) those providing the best (i.e. most cost-effective and innovative) solution to a specific issue.
- **Conditional Cash Transfers (CCTS):** Upon achievement of pre-agreed results (e.g. regular health care checks, increased school attendance) payments are made to disadvantaged households to stimulate investment in human capital.

Example of Impact Bond structures

- Trickle UP Foundation and three NGOs (Association Monde Rural, Alliance Internationale pour le Développement et la Solidarité en Afrique, Aid Aux Enfants) signed a PBC in 2015, which focused on implementing coaching services to support poor families in Burkina Faso to secure paths out of poverty. Payments were made contingent upon families living under USD 1.25 a day reaching specific economic stability targets. Outcome targets included levels of savings and confidence.

Examples of relevant terms (as formulated in a contract):	
Funding structure	Payments are made in proportion to achievements, and results are reported and verified (annually). Baseline for the disbursement linked indicators is in both cases (zero).
People provided with access to an improved water source under the programme:	A total of up to (USD 9,000,000) is allocated to this indicator, of which (USD 2,000,000) are available as an upfront payment. <u>Example for output indicator:</u> For each person served by an improved water source built under the programme, a payment of (USD 77.70) is provided. <u>Example for outcome indicator:</u> For each percentage of reduced diarrhoea morbidity in the defined communities a payment of (USD 350,000) is provided.

Number of new sanitation cabins equipped with handwashing facilities in schools built under the programme:	- A total of up to (USD 2,500,000) is allocated to this indicator, of which (USD 500,000) are available as an upfront payment. - Example for output indicator: For each new sanitation cabin equipped with handwashing facility in rural schools built under the programme, a payment of (USD 1,689) is provided. - In the event the number of sanitation cabins that are verified to be operational and properly maintained reaches at least (70%) of the number of sanitation cabins built in the previous year, an additional payment of (USD 150,000) will be provided. - Example for outcome indicator: For each percentage of reduced student absence in the defined communities a payment of (USD 50,000) is provided.

Main Advantages

- Contract is between two parties only, and thus not overly complex or costly.
- No investor needed and no financial returns to be paid.
- Encourages outcomes-focused innovation and performance management in development.
- Pre-defined outcomes align expectations.
- Greater flexibility for implementers.
- Potential introduction of regular outcomes-based commissioning for governments.

Main Challenges

- Appropriate measurement framework and payment metrics are critical for success, but require time and resources.
- Implementers need to have the capacity to absorb some of the (financial) risks.
- PBCs can have unintended effects such as market distortion and cherry-picking/creaming.

Case studies and additional resources about Performance-Based Contract can be found here.

OPPORTUNITIES FOR BANGLADESH

BOOSTING FINANCING FOR EARLY-STAGE IMPACT ENTERPRISES

The impact investment ecosystem in Bangladesh is the third largest in the South Asian region after India and Pakistan, respectively. In 2018, nearly 1 billion USD were invested in social impact activities in Bangladesh according to the OECD. These numbers paint an optimistic picture of the potential for the future. However, the numbers encapsulate some observations that point to underlying gaps in the impact investment ecosystem in Bangladesh. By and large, there is a fundamental mismatch between the type of actors providing finance, the size of that finance, and the target investee envisaged and the actual reality of impact enterprises in Bangladesh. This is even more accentuated for enterprises in their early stages. Furthermore, the disruption triggered by Covid-19 hits early stages impact enterprises seriously.

There is great potential for creating an enabling environment in Bangladesh that supports impact enterprises on their journey to create much needed impact at scale. A concerted effort by a multitude of stakeholders is needed for this including investors, intermediaries, professional service providers, and policy makers. Considering the societal benefits created by impact enterprises public authorities are instrumental in catalysing and supporting this movement.

Regulatory measures needed to enable more diverse, targeted and flexible impact investment

Currently, more than 90% of all impact capital came from Development Finance Institutions, who, by and large, have been looking for larger deal sizes and more mature enterprises - the lion's share of this in the form of debt.

In contrast, private equity investors and impact funds prefer venture capital or equity as a form of investment.

As demonstrated in this report, the new generation of investees will require more flexibility and support from impact funders, in particular with regards to the type and terms of the investment provided. However, innovative financing instruments that cater to the specific needs of early stage impact enterprises are still virtually unheard of in the Bangladeshi impact investing market. New laws and regulations that enable the deployment of more flexible forms of financing instruments for impact enterprises would be essential in removing barriers. Currently, the Government of Bangladesh defined 'Impact investment' under the Alternative Investment Rules 2015 which limits impact investment to equity and equity linked instruments:

> *Impact fund means an alternative investment fund, which invests in equity and equity linked instruments of such companies, organisations, and funds, which are engaged in activities with the intention to generate a measurable and beneficial social or environmental impact in addition to financial returns, as justified with internationally recognised criteria* [39].

Also, providers of debt need to be licensed as financial institutions which creates high entry barriers. As a result, many of the financing instruments that are essential in catering to the specific needs of impact enterprises highlighted in this toolkit are left out of the overall legal framework and are rarely used in Bangladesh.

To fully tap into the potential of impact enterprises in Bangladesh, legal and regulatory reforms are needed to enable the deployment of a wider spectrum of capital and financial innovations. The following provides a brief overview of potential actions that could be taken by regulators, policy makers, and other relevant actors.

Potential areas and actions that could be addressed by public authorities

- Enabling regulations for innovative financing instruments and models that meet the needs of high impact enterprises and their investors
- Introduction of impact measurement standards and certification approaches (leading to specific benefits for certified enterprises, e.g. preference in public tenders, tax breaks)
- Support programmes for incubation of startups in general and for social and impact enterprises in particular
- Simplified procedures for founding impact enterprises
- Support programmes for impact investment intermediaries bridging demand and supply as well as professional service providers focusing on enabling impact investment transactions
- Set up of catalytic funding vehicles by the government in order to mobilise private investment in priority sectors (using blended finance instruments, e.g. de-risking instruments like guarantees, matching funds or Impact-Linked Finance models)
- Tax incentives for investments in impact enterprises; this could include tax breaks for investors in (certified) impact enterprises and simplified procedures for tax declaration

We think the time has come for taking bold, collaborative actions for supporting a new type of enterprise to scale their positive impact for the people of Bangladesh.

39 Bangladesh Securities and Exchange Commission Notification dated June 22, 2015

ACRONOMYS & KEY TERMS

B-BRIDDHI	Biniyong Briddhi
BIDA	Bangladesh Investment Development Authority
BSEC	Bangladesh Securities and Exchange Commission
BoP	Bottom of the Pyramid
CCTS	Conditional Cash Transfers
CdA	Clinicas del Azúcar
DFIs	Developing Finance Institutions
DIB	Development Impact Bond
GIIN	Global Impact Investing Network
HNWI	High Net Worth Individuals
IRMF	Impact Ready Matching Fund
LC	Legal Circle
LCP	Light Castle Partners
MFIs	Micro Finance Institutions
MFN	Most Favoured Nation
NAB	National Advisory Board
NGOs	Non-Governmental Organisations
OBA	Output-Based Aid
PBC	Performance-Based Contract
PBF	Performance-Based Financing
PoC	Proof of Concept
ROI	Roots of Impact
RSA	Revenue Share Agreement
SAFE	Simple Agreement for Future Equity
SDC	Swiss Agency for Development and Cooperation
SDGs	Sustainable Development Goals
SIB	Social Impact Bond
SIINC	Social Impact Incentives
SMEs	Small and Medium Enterprises
SPV	Special Purpose Vehicle
TOC	Theory of Change
USD	United States Dollar currency

DEFINITIONS

Blended Finance,	it is the use of catalytic capital from public or philanthropic sources to increase private sector investments in developing countries to realize the SDGs.
Bottom of the Pyramid,	(BoP) it refers to the poorest of the socio-economic group, at the base of the wealth pyramid.
Business Angels,	they are also known as "Angel Investors", "Informal Investors", "Angel Funders", "Private Investors", or "Seed Investors". They are wealthy individuals who provide capital for a business startup, usually in exchange for convertible debt or equity of the company.
Catalytic Capital,	it is a form of funding that enables to improve the risk-return profile of an enterprise, thus mobilising greater capital and encouraging the flow of additional funding.
Concessionary Capital,	it refers to a type of funding characterised by below market return/rate.
Covid-19,	it refers to a new infectious disease caused by severe acute respiratory syndrome coronavirus.
Equity Kicker,	it is a feature that is added usually to a debt instrument to make it more appealing and desirable to potential investors.
Exit,	it refers to the moment and the methodology used by the investor to sell their stake in the company to realize positive financial gains.
First-Loss Capital,	it is defined as the capital which bears the losses prior to all the other sources of capital. It is usually used in order to catalyse the participation of other investors that would not have entered the deal otherwise, thus mobilising greater volume of capital that would not have been obtained otherwise. It is also known as "C-Shares", or "First-Loss Tranche".
Impact Enterprises,	it refers to a spectrum of enterprises that deliver social and/or environmental impact in a financially self-sustainable manner.
Impact Investment,	it refers to an investment which is intended to generate positive and measurable social and environmental impact alongside a financial return.
Impact Management,	it is a systematic process that helps to manage, measure, monitor and improve the impact of a business on its customers, suppliers, employees or society as a whole, and/or the environment.
Impact-Linked Finance,	it refers to linking financial rewards for market-based organisations to the achievements of positive social outcomes.

Incubator,	for the scope of this toolkit they also refer to "Accelerators" and "Service Providers", and they are organisations delivering programmes for entrepreneurs that may include seed investment connections, mentorship, educational components, and that may culminate in a pitch event to investors or a limited in time, and recruit cohorts of entrepreneurs at regular intervals. Accelerators and Incubators are essentially similar, the difference being that incubators specifically cater to early-stage enterprises that have been established recently (startups), while accelerators are targeting enterprises which are already more mature to help them accelerate their growth.
Innovative Finance,	it is a broad term referring to non-traditional financing mechanisms that match an enterprise’s business model, needs and stage of development, enabling the enterprise to raise capital to foster its development and ensure its success.
Loan Forgiveness,	it refers to the full cancellation of the outstanding loan amount owed.
Mission-Drift,	it refers to the circumstance when an enterprise has to compromise the initial organisational objectives and mission due to subsequent external events.
Operational Risk,	it refers to the internal risk an enterprise face when running its day-to-day operations, which is usually caused by malfunctioning or unexpected as well as expected breakdowns in internal procedures, people, and systems.
Pro-rata Rights,	they are rights entitling the holder to participate in subsequent round of funding, and to invest additional funds in order to preserve his or her ownership percentage and avoid dilution.
Result-Based Finance,	it is a broad term that refers to all investments that provide funding upon achievement of specific results.
Risk-Adjusted Return,	it is a return that is appropriate for the level of risk of an investment. The higher the perceived risk, the higher the expected return needed to compensate for that risk.
Series A,	it refers to the moment when an enterprise typically provides equity shares to investors for the first time in its history.
Stakeholders,	it refers to all parties that have an interest in a company and that could affect or be affected by the company’s actions and business.
Subordinated Capital,	it refers to a type of capital which is subordinate to other forms of capital in the distribution of payments in the event of a bankruptcy or winding up of a company.
Theory of Change,	it is generally defined as an extensive description of how and why a specific desired change is expected to happen.
Valley of Death,	it refers to the phase past the seed stages of financing, when an enterprise can unlikely meet the return requirements demanded by traditional private equity investors and venture capital funds, or provide for the adequate risk mitigation in order to have access to traditional debt providers such as banks. And as a consequence, the enterprise risks to fail due to lack of funding.

B-BRIDDHI

Scaling Impact Enterprises of Bangladesh

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