# 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).

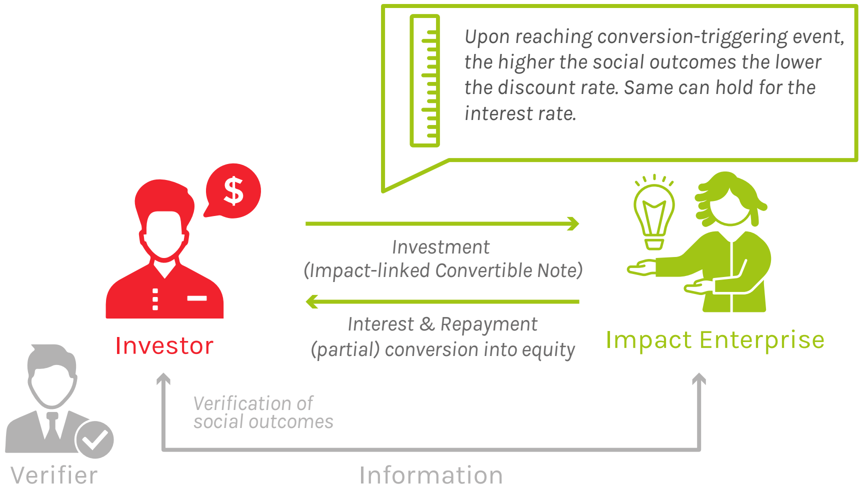


*Figure 3.5 - "Impact-Linked Convertible Loan" source: Roots of Impact.*

| | |
|---|---|
| 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%).<br>○ Maximum interest rate p.a.: (6%).<br>○ Minimum interest rate p.a.: (-10%) (partly debt forgiveness).<br>○ 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.<br>○ 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.<br>○ Maximum discount rate: (20%).<br>○ Minimum discount rate: (0%).<br>○ 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.