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.

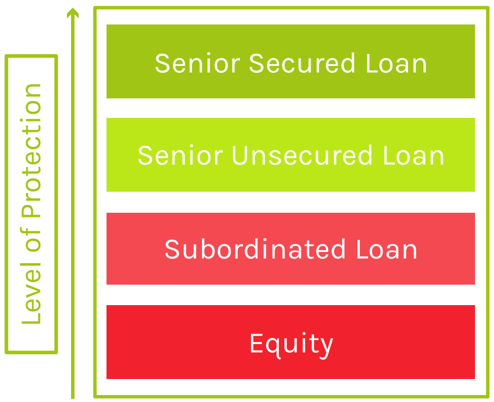

Figure 4.3 - "Subordinated Loan", source: Roots of Impact.

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%).

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

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.