



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

SUMMARY

ANDREA ARMENI WITH MIGUEL FERREYRA DE BONE

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About the Multilateral Investment Fund

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

About the Rockefeller Foundation

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

About Transform Finance

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

PREFACE

ELIZABETH BOGGS DAVIDSEN

Head of Knowledge Economy, Multilateral Investment Fund

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

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

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

From the workshops and Global Summit emerged a broad consensus that new solutions were needed to

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

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

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

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

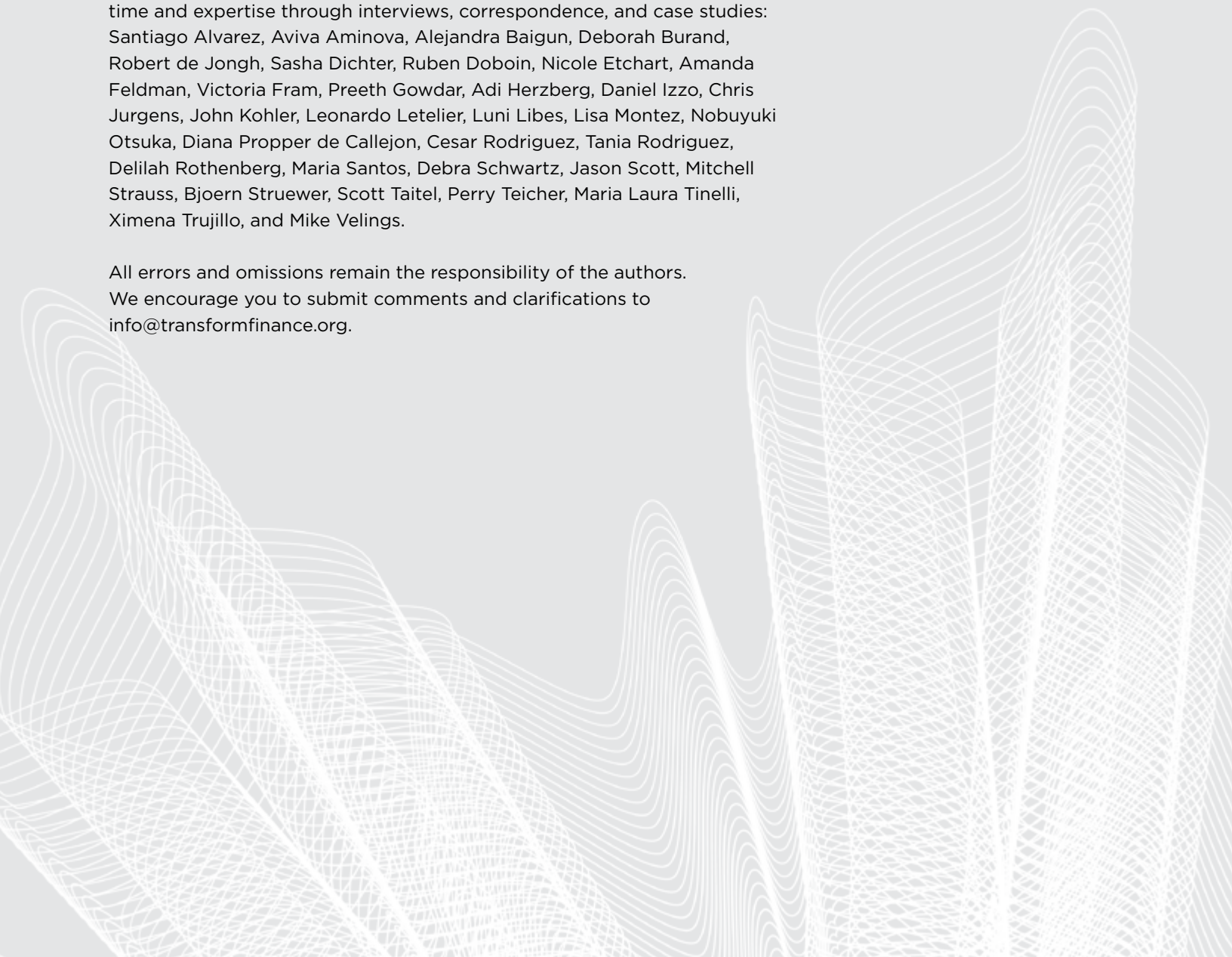
ACKNOWLEDGMENTS

The forthcoming report, *Innovations in Financing Structures for Impact Enterprises: Spotlight in Latin America*, could not have been written without the invaluable support of the fund managers, investors, entrepreneurs, practitioners, advisors, and experts in the impact investment field who openly shared their knowledge and experience with early and growth-stage investments in Latin America and beyond.

A very special thanks is due to Aner Ben Ami of Candide Group, Bruce Campbell of Blue Dot Advocates, Elizabeth Boggs Davidsen of the Multilateral Investment Fund, Laurie Spengler of Enclude, Lorenzo Bernasconi of the Rockefeller Foundation, and Rodrigo Villar of Adobe Capital who have been field innovators and thought partners in the work leading up to the forthcoming report.

We would also like to thank the practitioners who have kindly shared their time and expertise through interviews, correspondence, and case studies: Santiago Alvarez, Aviva Aminova, Alejandra Baigun, Deborah Burand, Robert de Jongh, Sasha Dichter, Ruben Doboin, Nicole Etchart, Amanda Feldman, Victoria Fram, Preeth Gowdar, Adi Herzberg, Daniel Izzo, Chris Jurgens, John Kohler, Leonardo Letelier, Luni Libes, Lisa Montez, Nobuyuki Otsuka, Diana Propper de Callejon, Cesar Rodriguez, Tania Rodriguez, Delilah Rothenberg, Maria Santos, Debra Schwartz, Jason Scott, Mitchell Strauss, Bjoern Struewer, Scott Taitel, Perry Teicher, Maria Laura Tinelli, Ximena Trujillo, and Mike Velings.

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

SUMMARY

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

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

The financing gap for early and growth-stage impact enterprises has been well analyzed. Building on that foundational analysis, this report focuses specifically on the opportunity to capitalize the enterprises via alternative financing structures that go beyond traditional debt and equity and are especially well suited to the variety of markets, sectors, and conditions in which the enterprises operate. Based on that work, the Multilateral Investment Fund (MIF) has been supporting the development of alternative financing structures to increase the menu of opportunities available and overcome this challenge.

Growing interest in the financing needs of impact enterprises has given rise to meaningful experimentation in deal structuring and the emergence of some early good practices among entrepreneurs and investors. Three clear trends have emerged: the tremendous appetite for different forms of capital, the existence of a budding marketplace of innovation in financing structures, and the need to do more. The Transform Finance/MIF partnership is preparing a report that aims to foster the flow of more capital that is adequate for early-stage and growing impact enterprises by addressing practically each of those three points. The research and exploration done for the forthcoming report was supplemented with direct engagement with fund managers, asset owners, and impact entrepreneurs to ensure its practicability.

This summary of the forthcoming report provides an overview of three main areas of inquiry:

- 1. Document the need:** Review the reasons why traditional debt and equity capital may not fit the needs of impact enterprises and explore how alternative financing structures may be better aligned.
- 2. Point to solutions:** Describe some of the alternative financing structures that have emerged as promising models, for both debt and equity investors, which will be accompanied by case studies in the report.
- 3. Pave the path:** Provide initial recommendations for what can be done to foster more widespread adoption of alternative financing structures.

1. The Need for Alternative Deal Structures

INVESTOR CHALLENGES

Investors cite several reasons why they are unable to meet the capital needs of impact enterprises through traditional deal structures. Enterprises that do not have the potential to reach scale and exit, lack collateral, or have yet to reach positive cash flow, get left behind. To understand the need for alternatives, the study captures some of the principal challenges traditional debt providers and equity investors face with impact enterprises.

HIGHER PERCEIVED RISK

Impact enterprises typically do not have established relationships with lenders and many lack the collateral that is almost universally required to obtain loans from commercial banks and other financial institutions. This inability to offset risk, common for most small and medium enterprises, renders banks and other debt providers more cautious and reduces the availability of loans. More importantly, banks are less familiar with the particular markets and models of impact enterprises, which reduces the likelihood that they will lend. Even where loans are available, debt service can be problematic: For impact enterprises, traditional debt repayment schedules may be difficult to match to the cash flow projections and their risk profiles can result in high interest rates that can hinder their development.

LOWER EXPECTED RETURNS

Some impact enterprises tend to address market failures or areas where entrepreneurs purely seeking returns have not engaged. This means that the expected returns are, as a general matter, less compelling for investors. As a corollary, impact entrepreneurs often face a trade-off between impact and profitability. In a context where even impact investors are looking for venture capital-like “home runs” and market-rate returns on early-stage and growth-stage equity, most equity investors eschew enterprises that could deliver high impact, but, despite

their overall financial viability, could not deliver high financial returns. This leaves unfunded a major slice of the investable universe of impact solutions.

LONGER TIME HORIZONS

Impact enterprises often address complex problems in complicated markets, which can slow business development. Their business models may be untested and the time to achieve profitability—as well as to achieve impact—is often longer than for traditional enterprises. An equity investor expecting a meaningful return in five to seven years may be disappointed despite the long-term viability of the enterprise. Similarly, traditional debt providers, such as banks, may not be able to match their timelines to those of the enterprise. This is especially the case where the product intrinsically requires a longer time to reach maturity, as for agroforestry businesses where the time to harvest can be 10 or more years.

HARDER AND SLOWER PATH TO SCALE

In terms of scale, equity investors’ aspirations for rapid growth do not align well with the realities of impact enterprises. In some cases, the enterprise may grow more slowly, in others, it may simply be unsuited for scaling up. The tendency of equity investors to push companies to grow and scale up quickly may, rather than supporting rapid success, instead push impact enterprises faster toward failure.

FEWER EXIT OPPORTUNITIES

Barring an unlikely initial public offering, the traditional equity exit comes from a merger or acquisition. However, many impact enterprises operate in social sectors where there are fewer M&A events, apart from a few notable exceptions such as in the medicine and health-tech sectors. This lack of a vibrant M&A environment—whether as a matter of market or of sector—is itself a deterrent for a typical equity investor. With few exit opportunities, there is an

inherent risk of pushing toward an exit to a buyer that is not aligned with the mission of the enterprise and is likely to compromise its impact goals.

HIGHER TRANSACTION COST

Transaction costs are comparatively higher, relative to invested amount, for smaller deals. The peculiarities of impact enterprises—from their unique market positioning to the lack of established banking relationships—also make for higher transaction costs, which decrease the relative availability of capital.

ENTREPRENEUR CHALLENGES

Impact enterprises, by their nature, differ in goals and aspirations from traditional enterprises. They may view financial returns as a means to sustainability rather than an end in themselves. They may address local challenges without a view toward replication and continuous scale. From the perspective of capital being at the service of the enterprise, impact entrepreneurs and their funders highlighted several challenges.

LONG-TERM COMMITMENT TO ENTERPRISE

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

LESS EMPHASIS ON EXITS

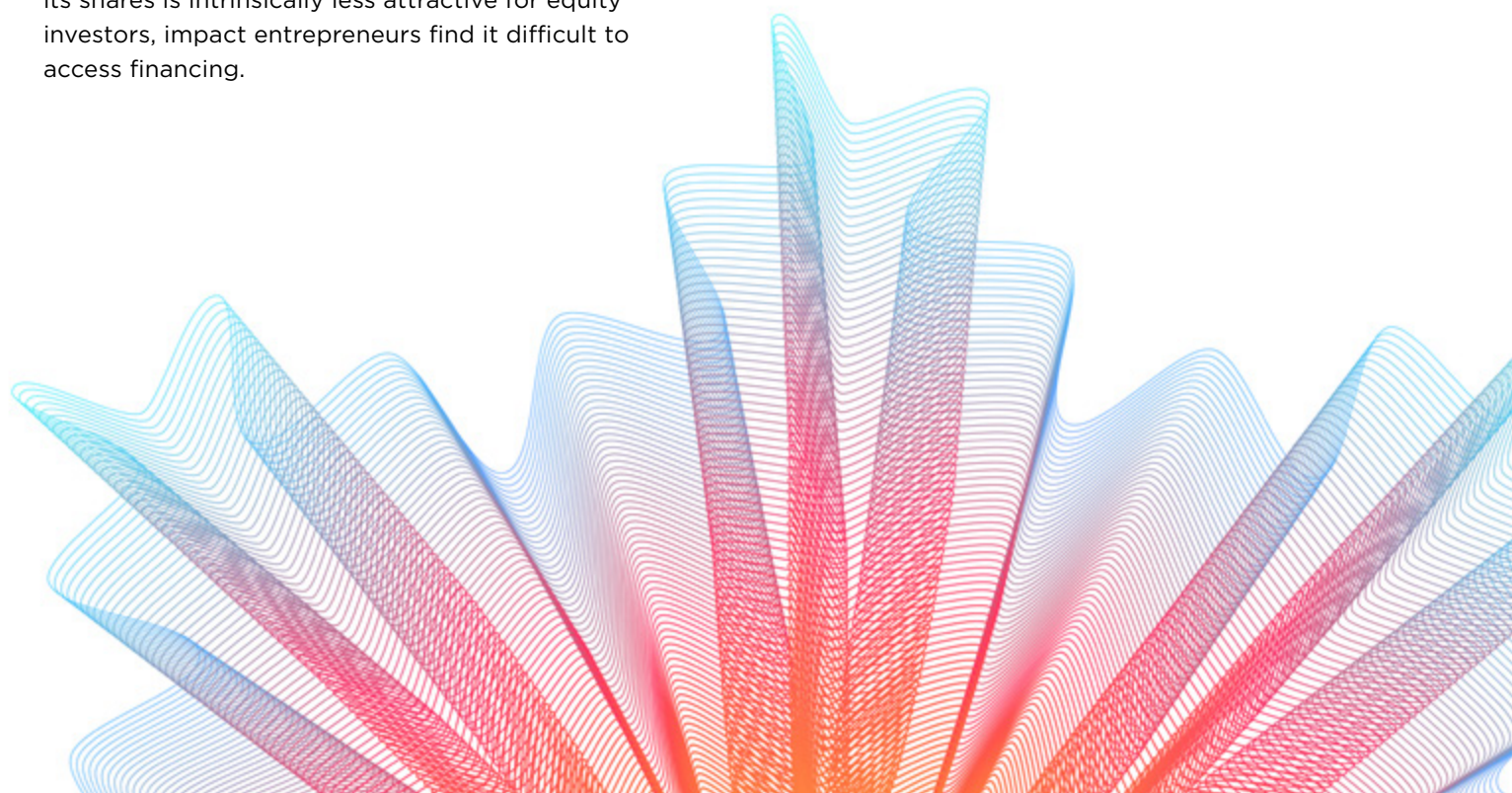
Impact entrepreneurs, rather than looking for an exit, may want to hold on to a business and benefit from its cash flow. Concerns about community jobs or the provision of local services in the case of an exit also militate against taking on the type of financing that could result in a departure of the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

CONCERNS ABOUT PRESERVING THE MISSION

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

HIGH COSTS OF FAILURE

Since impact enterprises address particular social or environmental challenges, their failure may have significant implications in the social conditions of their clients and the environment. The consequence of a potential failure in most cases goes beyond the enterprise itself and can have tangible negative impacts upon the communities it has been serving.



2. Alternative Deal Structures

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

THE RISE OF ALTERNATIVE DEAL STRUCTURES

A universe of alternatives between the poles of straight debt and straight equity already exists and may be a good fit for financing impact enterprises. Recent years have seen an increase in experimentation, especially in Latin America and particularly around flexible debt and revenue-based loans that offer some equity-like gains.

There has also been an increased commitment of capital from a growing community of investors who are not seeking venture capital-like “home runs” from their support of impact enterprises. Many, in fact, may prefer smoother returns via a clear path to progressive liquidity, so that the funds can cycle back into more impact enterprises, rather than a quest for less likely, but higher, return multiples.

Opportunities to innovate in alternative deal structures exist all along the financing risk continuum, from grants, to equity, to debt instruments. Within the equity and debt categories, these alternative structures are most similar to traditional financing—both categories are suitable for a range of risks and returns and are often encountered in contexts other than impact investing. Alternative grant structures are more suited to the participation of a philanthropic investor, and as such are less common; nonetheless, they can also encompass terms borrowed from debt

and equity. The forthcoming report presents case studies that exemplify the current landscape and the potential applicability of emerging models.

The alternative grant instruments differ from traditional donations in that they embed the possibility of repayment. For example, grants can be repaid contingent upon enterprises reaching specific growth milestones or securing a next round of financing. Another alternative grant mechanism provides a bonus to the enterprises upon achievement of impact milestones. (These impact incentives are similar to pay-for-success models. However, this report will not include a discussion of social impact bonds or similar pay-for-success models.)

Unlike typical equity deals, the equity models presented differ in that they provide for predetermined liquidation mechanisms. For example, deals can be structured so that investors can sell shares back to the company at fair market value or based on a predetermined formula. These equity redemptions can either be at the end of the investment period or redeemed gradually. They can also be either mandatory or structured as an option. Another equity structure builds-in dividends and distributions to investors, either based on cash flows or a percent of revenues or profits. In these dividend and distribution deals, the company commits to making distributions to the investor until a hurdle is achieved.

FORTHCOMING CASE STUDIES ON ALTERNATIVE DEAL STRUCTURES

Adobe Capital	Revenue-Based Mezzanine Debt
Eleos Foundation	Demand Dividend in Maya Mountain Cacao
Enclude	Variable Payment Obligation
Village Capital	Revenue-Based Loan in Ag Tech Company
La Base / The Working World	Flexible Debt for Worker Recovered Companies
Inversor	Combined Structured Equity and Variable Debt
Acumen	Self-Liquidating Structure for Investing in Cooperatives
Multilateral Investment Fund	Reimbursable Innovation Grants
NESsT	Recoverable Grants as Seed Investment
Rockefeller Foundation	Social Success Note
Roots of Impact	Social Impact Incentives (SIINC)

The alternative debt instruments allow for higher levels of risk, often compensated by higher potential upside. Some of these loans, for example, require the company to make periodic payments based on a percentage of revenue, profit, or another financial indicator. Other loan models combine flexible repayment schedules with other return incentives.

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

The choice among these structures is generally based on the stage of the enterprise, its cash flow potential, expected time to profitability, potential exit opportunities, the need for downside protection, and the investor and entrepreneur preference between debt and equity (including tax considerations).

3. Alternative Fund Structures

The traditional capital aggregation model of the closed-end fund has shown limitations for impact enterprises, in particular due to the longer timeline to returns that many such enterprises have and the lower likelihood that one enterprise can “return the fund” as expected in venture capital funds. The requirement for the fund manager to return capital to investors within a few years can create a mismatch for an otherwise financially viable impact enterprise that would require a longer time to reach maturity than what the fund can provide.

Two innovations have emerged for capital aggregation: holding company structures and open-ended funds. These models, widely used in traditional finance, are suitable for impact enterprise financing. The forthcoming report provides case studies of several open-ended funds and holding company structures.

CLOSED-END FUNDS, OPEN-ENDED FUNDS, AND HOLDING COMPANIES

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

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

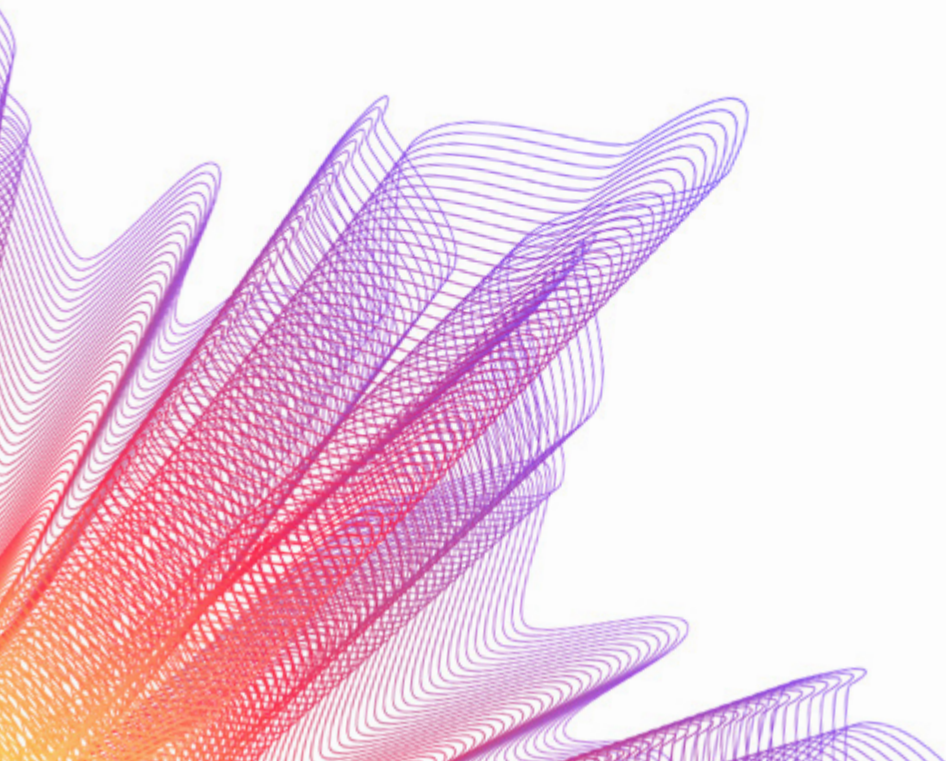


In contrast, in open-ended funds, there is no time limit for fundraising nor for when the fund must be liquidated. Investors, rather than pledging capital for future draw-downs, provide the capital upon entering the fund, and have flexibility for when to exit. With no set investment period or fund lifetime limit, open-ended funds are able to keep enterprises in their portfolios for longer periods, as they seek the increase in the value of their portfolio companies. These characteristics enable the open-ended fund structure to address a major problem for impact enterprises in a closed-end fund: there is no need to chase an exit by a particular time. An open-ended fund may maintain enterprises in its portfolio indefinitely, and the value is returned to the investors into the fund in the form of dividends and appreciation. On the enterprise side, this means less pressure to grow on a schedule that matches the life of a closed-end fund.

The holding company structure, or HoldCo, provides another alternative to closed-end funds. A HoldCo is not a fund, but a parent company that owns a portfolio of subsidiaries, often within the same geography or sector in order to promote synergies among the enterprises. The structure as a company, rather than a fund, means that capital invested in a HoldCo is more liquid than that in a closed-end fund—to the extent that there is a market for investors to enter and exit the HoldCo. Like open-ended funds, HoldCos do not have a forced exit, providing similarly favorable conditions for impact enterprises. HoldCos can be particularly attractive where the underlying enterprises have a clear but longer path to cash flow due to a longer business cycle, where they operated in illiquid markets, or where there are strong synergies across the portfolio (for example, with a portfolio of agricultural investments across the supply chain in Central America).

FORTHCOMING CASE STUDIES ON ALTERNATIVE FUND STRUCTURES

Encourage Capital	HoldCo Structure: Pescador Holdings
Aqua Spark	Open-Ended Fund
Triodos Bank	Open-Ended Triodos Organic Growth Fund
Enclude	Offshore Investment Vehicle



4. Recommendations

Given the compelling reasons for innovation in alternative financing structures and the existence of viable models currently being used in Latin America, several steps can be taken to ensure continued innovation and broader adoption. Preliminary needs and recommendations are listed below.

STANDARDIZATION

There is no standard form in the way alternative structures are built and marketed—they are tailor-made solutions. The lack of standardization not only makes the structures less well known but also creates higher transaction costs and makes alternative structures more time consuming to execute. This issue is even more salient among institutional investors who seek structures that fit within pre-defined investment policies.

A balance is needed between bespoke structures that meet the needs of a specific context and standardization that allows more capital to flow to impact enterprises. Systematizing existing deals and term sheets, together with incentives for transparency in information would reduce transaction costs and time, and would drive more capital to impact enterprises. The Impact Terms Project (www.impactterms.org) has made significant strides toward this goal. To move this further, investors can make an important contribution by sharing their experiences and investment documentation.

INCREASED FAMILIARITY AMONG ENTREPRENEURS

Many entrepreneurs are not familiar with alternative financing structures, even where they would benefit from them. In many instances, venture capital models are the default for an entrepreneur looking to grow. Accelerators and advisors working with impact enterprises also often do not feature or highlight alternative financing options.

This shortcoming can be addressed through targeted communication about alternative financing structures and through strengthening education programs available to entrepreneurs, especially as part of the curricula of accelerators.

INCREASED FAMILIARITY AND COMFORT AMONG LIMITED PARTNERS AND FUND MANAGERS

Fund managers are concerned that using nonstandard structures will make the fundraising process harder, in part because they are less familiar to potential investors. There is, however, a growing community of limited partners that have experimented with alternative financing structures at the direct deal level, who may be particularly interested in managers that apply them at the fund level.

Educating investors and lenders, as well as incubators, accelerators, and other intermediaries on the opportunity for investing in funds that pursue alternatives is a first step. Limited partners interested in alternative financing structures could also commit to anchoring new funds that wish to experiment but fear negative investor reaction.

SOCIALIZING THE SUCCESS STORIES

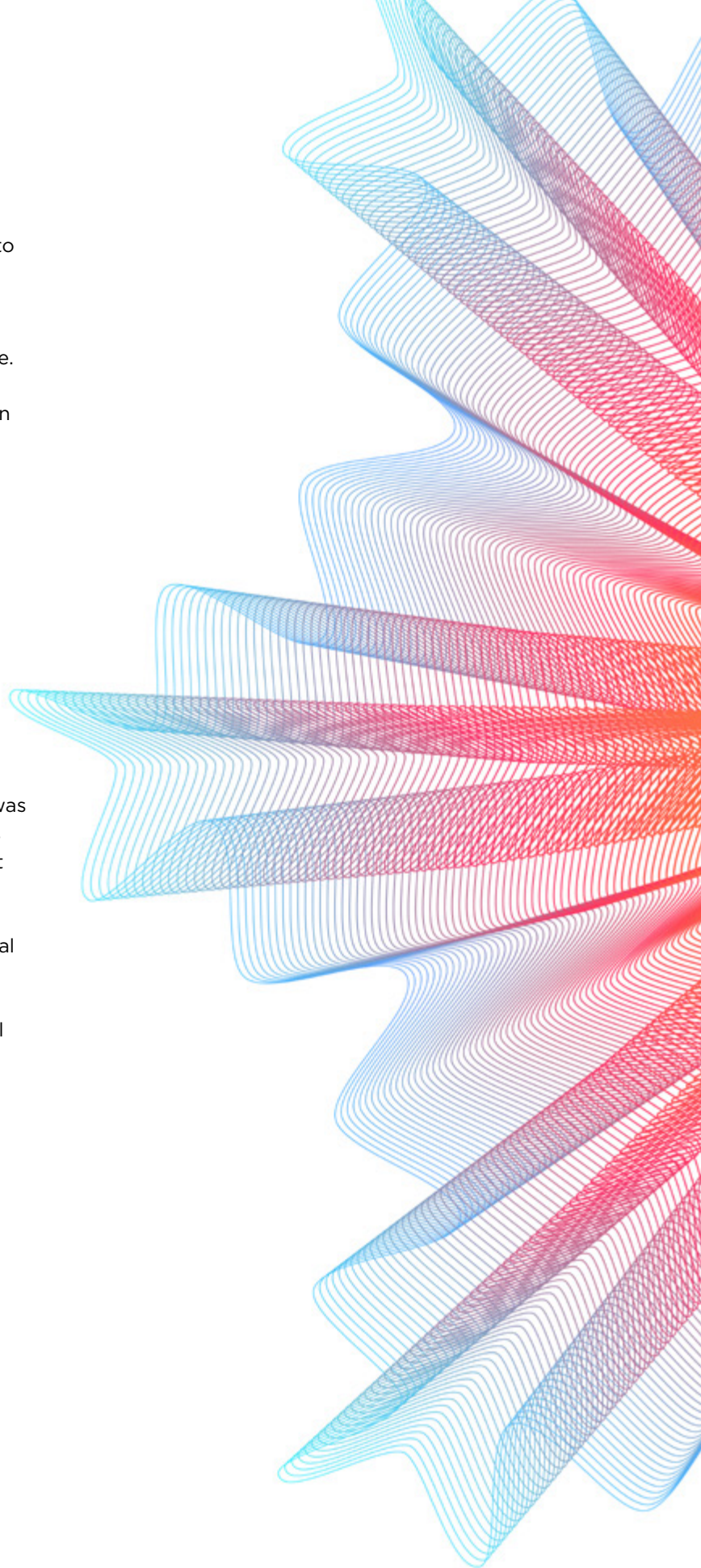
Entrepreneurs and investors are less familiar with success stories in alternative financing, as opposed to the more broadly celebrated traditional exits. Many entrepreneurs still equate success with a traditional venture capital round of financing, regardless of whether that is what is most suited for the enterprise.

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

CREATION OF A SEPARATE ASSET CLASS

What is now considered traditional venture capital was deemed esoteric until just a few decades ago. It was only when venture capital consolidated into an asset class that it experienced its dramatic expansion.

It is easy to envision a similar path for alternative deal structures, were they to be systematized into a set of opportunities with similar characteristics, which would open them up to a broader group of potential investors. This possibility should be kept present as the field seeks to standardize terms.



5. Conclusion

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

The examples offered in the forthcoming report present a solid argument for exploring further adoption and continued experimentation.

As a next step, the stakeholders in impact investing should explore ways in which they can continue to advance alternative financing structures. Multilaterals and less constrained asset owners, such as family offices, can play an especially important role in advancing experimentation and adoption.

We encourage you to submit comments and to request a copy of the forthcoming report by contacting info@transformfinance.org



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