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# Innovative Deal Structures for Impact Investments

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## Project Summary

Impact Investors often rely on conventional term sheets to structure investments. This can create challenges and even potential conflict between capital providers and companies given that not all investments in social enterprises conform to traditional investment terms. To address these challenges, a number of investors have begun to test new models for structuring investments, and are adding entirely new terms to address impact. The changes and innovations that have been tried remain largely unknown to others in the market. Through interviews and group discussions with investors, entrepreneurs and other leaders in impact investing, this project's goal is to develop an easily accessible on-line toolkit of innovative terms that will include new terms that are being piloted as well as new ideas that are at the conception stage.

Diana Propper de Callejon, Managing Director at Cranemere Inc., has 20+ years of sustainability investment experience and developed the term sheet project as a part of her Aspen Institute and Capital Institute Fellowships.

Bruce Campbell, Chief Happiness Officer at Blue Dot Advocates, has worked as a corporate finance lawyer for 15+ years and has an extensive track record structuring impact investments.

Pi Investments

**If you have any questions, comments or contributions, please contact n.taylor.thompson@gmail.com**

## Background

Impact investors often rely on traditional term sheets to structure their investments. While familiar and well tested, they are not always the most effective way to structure investments into companies that are explicitly oriented towards social or environmental mission and profit.

First, conventional venture capital and private equity term sheets expect a financial return to come from an exit in the form of a trade sale, IPO or sale of the business to an institutional investor. While some impact enterprises may have the potential to attract a strategic acquirer or have access to the public finance markets, in other cases these paths to exit are either unrealistic or undesirable. This can be for a number of reasons, including the following:

- Growth rates and scale of the enterprise: the company's business model reaches its growth projections over a period longer than 3-5 years and/or its ultimate size and scale may be limited by a smaller target market;
- Founder's goals: the founder's long-term goal may be to keep the company private to more easily preserve the company's social or environmental mission;
- Returns: some mission-led companies may deliver concessionary returns.

For companies that are less likely to complete a traditional exit for their investors, alternative exit strategies must be utilized.

Secondly, conventional term sheets are silent on matters related to impact and thus fail to capture the full breadth of interests and goals of the investors and companies. Term sheets constructed with a new approach can, on the other hand, play a central role in aligning interests and behaviors related to the achievement and preservation of mission.

To address these challenges, a number of impact investors have begun to develop new models for achieving liquidity and integrating impact directly into deals. Much of this knowledge, however, remains fragmented with no central clearinghouse to gather and disseminate the new approaches and lessons learned.

## Key Findings to Date

The team has interviewed almost 100 impact investors, enterprises, legal experts, and advisors from around the world. Our key findings, focused primarily on privately held, early-stage businesses, are summarized below.

### Equity investors are using innovative approaches to achieve liquidity, including staged dividend payments and redemption based exits.

Equity based alternatives encompass the following approaches:

1. Dividend payments: Partial or complete liquidity is achieved through staged dividend payments to investors. The company is required to make payments until they achieve a specified cash-on-cash return target. These payments are variable – they are linked to a percentage of revenue or cash flow, and thus link the timing of liquidity to the health of the enterprise. Typically, returns are capped or have certain limits on them, but sometimes investors have a mechanism to participate in a higher return if the enterprise successfully completes a traditional exit.

2. Redemptions: At the investor's option, an exit is achieved through the mandatory redemption of an investor's equity stake in the business at a specified point in time. We have seen the redemption amount paid to investors calculated in a variety of ways, including as a percentage of revenue, based on the fair market value of the company at a given point in time and as a pre-determined multiple on investment. Redemption provisions usually include some flexibility with respect to repayment in the event the company does not have adequate cash on hand to satisfy the redemption request.

These alternatives offer a solution to exit challenges by shifting the investor's risk adjusted return perspective. By predetermining liquidity payments, investors trade the higher potential upside from a traditional exit, for more certain repayment terms and less risk. For most of these investments, investors we interviewed are targeting IRRs in the mid-teens (with a few even higher). These investments are better suited for investors looking to invest in companies that are likely to generate sufficient profits from operations in the relative short term from which to provide staged liquidity payment to investors rather than VC-style investors that are willing to accept a high degree of risk for significantly higher return potential.

## Debt investors are adapting traditional structures to increase flexibility and alignment with enterprises.

Debt based alternatives offer the following new terms and adaptations to traditional debt:

1. More flexible repayment: Like some of the equity structures, some investors are linking debt repayments to a percentage of revenues or cash flows. This makes the timing of the repayment contingent on the company's performance, rather than fixed payments.

2. Longer time horizons: Investors have been willing to lengthen the term of the debt repayment, extending payments out as far as 10 years, or to offer longer repayment grace periods of 18-24 months and beyond.

3. Company friendly terms: Investors have included more company-friendly terms, including no pre-payment penalties and, in some cases, pre-payment discounts.

These structures can be advantageous for companies with return profiles that are not suitable for equity investment, but that also struggle to attain commercial loans due to unpredictable cash flows or a lack of security to offer as collateral.

## Revenue share agreements offer investors an alternative liquidity structure.

Revenue share agreements offer investors a simple way to participate in the growth of a company without purchasing ownership, and therefore avoiding exit issues. These structures entitle the investor to an agreed upon percentage of a company's revenue stream over a certain period of time. Typically, the revenue payments are limited by time or a capped multiple to the investor.

## Innovative investment structures may present challenges and trigger potentially disadvantageous tax issues.

These approaches have only begun to be tested recently (some have yet to be used) and none have been through a full investment cycle. We have no data as yet to conclude that these terms will successfully lead to the targeted financial outcomes or create better values alignment between investors and companies.

We have found that these innovative investment structures require careful tax analysis. If investors are not well informed about the tax aspects of these investments, they may end up paying more taxes than they expected and paying those taxes before the investment has realized a cash return. See the recent blog from Blue Dot Advocates for more on the tax considerations for these types of investments: www.bluedotlaw.com/innovative-financial-structures/.

## Impact investors are incorporating impact considerations into deals

Investors and companies are integrating impact considerations in a variety of ways:

1. Mission definition: Investors require the mission of the enterprise to be articulated as part of the term sheet, By-Laws and Articles of Incorporation.
2. Use of funds to invest in impact: Some investors restrict the use of funds to business operations that drive impact outcomes.
3. Impact governance: Impact governance is integrated at the Board level, including the appointment of at least one board member who has oversight of impact.
4. Linking returns to impact outcomes: Investors link their financial returns to the impact that the enterprise achieves. In some cases, they are inversely related, such that the investor accepts a lower return if the company achieves certain target outcomes. In other cases, they are positively related, such that the higher the impact, the higher the return to investors (e.g. Pay for Success model).
5. Mission preservation at the exit: Different approaches include providing founders with veto power to block an exit if they believe it to be in conflict with the enterprise's mission. Alternatively, the fiduciary duty of the Board can be redefined through an alternative entity such as the Benefit Corporation or through the operating agreement of a limited liability company to allow it to give equal consideration to impact preservation when evaluating an exit for investors.