INVESTING *FOR* IMPACT

EVPA TRAINING

FINANCING FOR SOCIAL IMPACT

Financial Instruments Overview

Financial instruments are contracts involving monetary transfers through which investors *for* impact financially support social purpose organisations (SPOs).

Grants are a type of funding in the form of a cash allocation that investors *for* impact can offer to SPOs. From SPOs' perspective, grants do not foresee any type of repayment or any financial returns to be given back to the investor. From the investors' perspective, grants do not establish any ownership rights.

Debt instruments are loans investors *for* impact can provide SPOs with charging interest at a certain rate. The interest charged can vary depending on the risk profile of the investee (i.e. the SPO); on its potential social impact; and on the securitisation and repayment priority of the loan (e.g. senior vs subordinated loan).

Equity instruments are contracts through which investors *for* impact provide funding to SPOs and in return acquire ownership rights on part of the SPOs' businesses. This form of capital can be appropriate when the prospect of a loan repayment is low or non-existent. If the SPO is successful, the equity share holds the possibility of a financial return in the form of dividend payments and/or the capital gain at the exit. In addition, it allows for the possibility of a transfer of ownership to other funders in the future.

PROS AND CONS OF THE MAIN FINANCIAL INSTRUMENTS

Grants are particularly well suited to situations where the possibility of generating earned income is highly unlikely, undesirable or difficult to achieve within the investment horizon of the investor *for* impact. Grants are fundamental to creating a market or to financing a public good that no private investor would support at any point in time. Grants help build proof of concept at seed stage. However, grants have the potential to create a situation of dependency of the SPO, if not provided with adequate non-financial support to strengthen the financial sustainability and organisational resilience. Grants might give SPOs little incentives to maximise efficiency of funds, scale operations, and reach sustainability.

Debt instruments are considered when the investor *for* impact is looking for a fixed term and fixed return. For the investor, they are “safer” than equity, but they do not allow the investor to have any control over the decisions of the SPO. Additionally, SPOs in the very early stage of development might not have any collateral to offer, which implies that the exposure of the investor *for* impact might end up being the same as if it was investing through equity.

Equity instruments should be considered when there is, or is likely to be, a market available for the SPOs' products / services / activities. For the investor, equity guarantees a participation in the financial upside of the business but implies to also share risks and liabilities with the investee. The return on investment may take place over a very long time period and may require significant amounts of other sources of capital (e.g. grants) to achieve it.

Hybrid financial instruments (HFIs) are monetary contracts that represent a variation or combine features of the traditional FIs (grants, debt instruments and equity instruments) in order to achieve the best possible alignment of risk and impact/financial return for particular investments. Even though HFIs can be very useful to better customise the support to SPOs, they require financially-literate organisations to invest in, which can understand the way of functioning of such instruments.

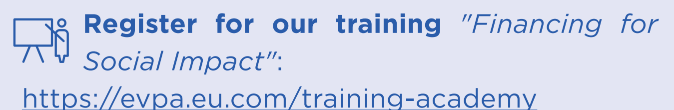
Mezzanine finance is a hybrid of debt and equity financing, usually used to fund the scaling of an organisation. Although it is similar to debt capital, it is normally treated like equity on the organisation's balance sheet. Mezzanine finance involves the provision of a high-risk loan, repayment of which depends on the financial success of the SPO. This hybrid financial instrument bridges the gap between debt and equity/grant through some form of revenue participation.

Convertible loans (or **convertible debt**) are loans that may be converted into equity. Convertible loans are most often used to support SPOs with a low credit rating and high growth potential. Convertible loans are also a frequent vehicle for seed investing in start-up SPOs, as a form of debt that converts into equity in a future investing round. It is a hybrid financial instrument that carries the (limited) protection of debt at the start, but shares in the upside as equity if the start-up is successful, while avoiding the necessity of valuing the company at a too early stage.

Recoverable grants (or **convertible grants**) are grants that investors *for* impact use to fulfil a role similar to equity. Recoverable grants may include an agreement to treat the investment as a grant if the SPO is not successful, but to repay the investor *for* impact if the SPO meets pre-agreed KPIs with success. Recoverable grants are designed to focus the SPO on sustainability and to reduce its risk of grant dependence.

MORE INFORMATION

Download our report *"Financing for Social Impact | The Key Role of Tailored Financing and Hybrid Finance"*: https://evpa.eu.com/knowledge-centre/publications/financing-for-social-impact



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Soft loans are debts investors *for* impact offer to SPOs with no interest (i.e. 0% interest rate loans) or with a below-market rate interest. The main difference with recoverable grants lies in the repayment scheme, which is agreed ex-ante between the two parts and it is not conditional to any specific KPI.

Revenue sharing agreements (or **royalty-based financing**) are hybrid financial instruments in which the investor *for* impact lends money to the SPO against its future revenue streams. The initial capital plus an additional interest has to be repaid by the company until the pre-established amount is paid back (so called royalty cap), with repayments only starting when the company generates positive cash flow. Investors obtain returns as soon as the investees reach an agreed level of revenue. (Source: **European Commission, 2017**.)

Forgivable loans are the opposite of convertible grants. They are loans which are converted into grants in case of success. If the SPO reaches the goals agreed on beforehand by the investor and the investee, the loan does not have to be repaid. The SPO bears the full risk of project success and, on top of that, has a strong incentivation for making it happen as planned. (Source: **Oldenburg and Struewer, 2016**.)

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