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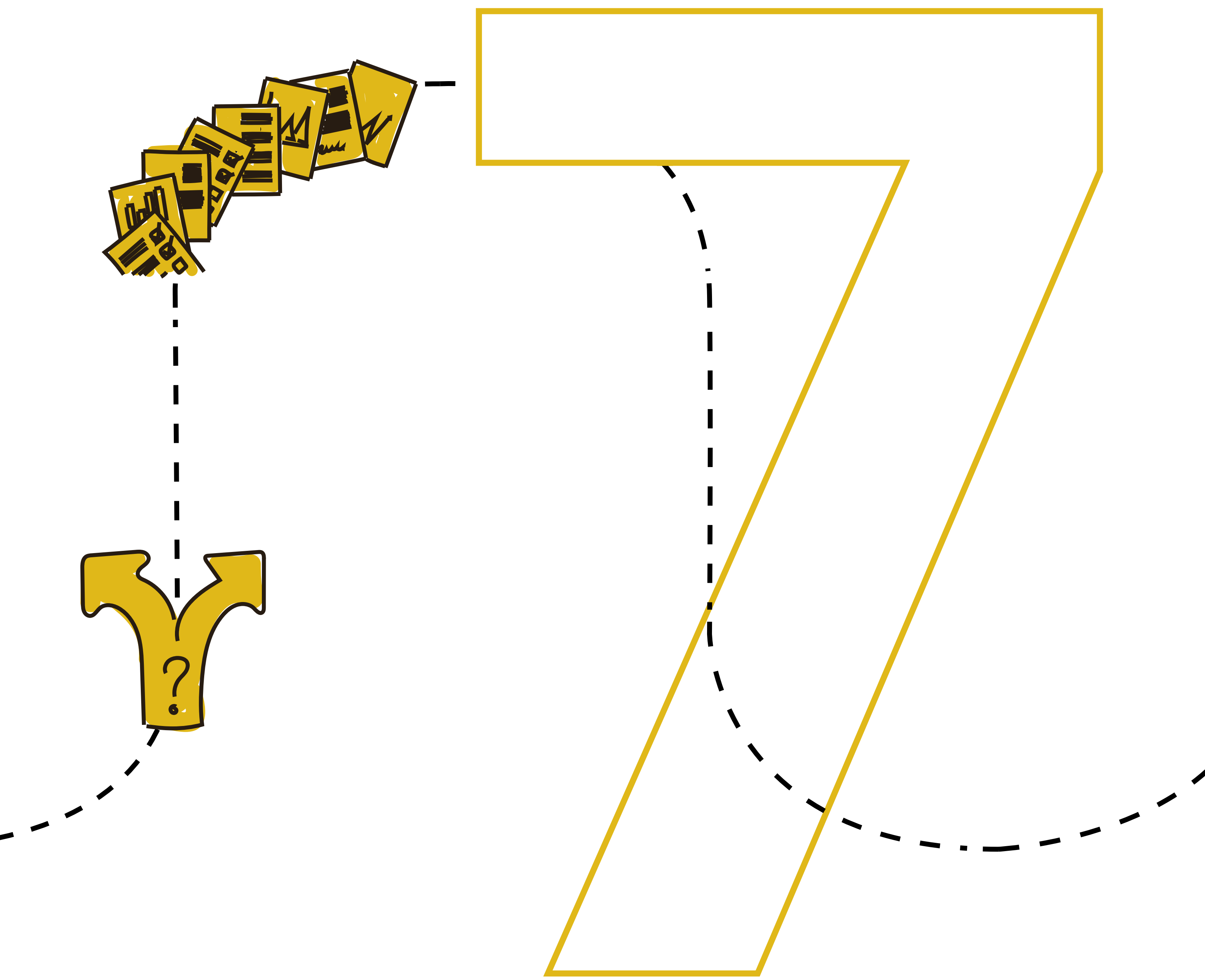
Financing Terms

Choosing a Financing Option

Social Investment Toolkit | Module 7



Version 1.0

Content

In this Module, we will cover:

- How much funding should you raise?
  - How to use Funding Milestones
  - Calculating your Cash Burn Rate
- What are your Financing Options?
  - Philanthropy
  - Equity
  - Debt
  - Working Capital Facilities
- Which Financing Option should you pick?

By the end of this Module you will have worked out how much funding you wish to raise and to have selected a suitable financing option.

We are keen to receive your feedback for the Social Investment Toolkit.

Module Checklist: Before You Start

Before starting this Module, you should have:

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- Developed a Social Business Model
- Set out your activities into core 'products and services'
- Calculated the price and cost of each of these activities
- Have an estimate of salaries, overheads and any other expenses you will incur

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- Created a growth forecast for each of your activities
- Have an estimate of what you might need to invest in to grow your venture

By 'products and services' we mean any activity which you provide to a customer or beneficiary on a consistent basis which might need funding. This approach is therefore applicable for any kind of social venture, including a pure charity that does not have a commercial business model.

If you haven't yet finalised any of the above items, we recommend that you read the relevant prior Module of the Social Investment Toolkit before embarking on this Module.

Introduction

If you have completed the earlier Modules in this Social Investment Toolkit, you are now ready to begin preparing an investment offer for social investors.

This Module is designed to help you with this next step, and in particular to help you answer three questions:

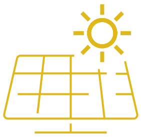
1. **How much** finance should you raise?
2. **What kind** of finance should you raise?
3. **What terms** should you offer to investors?

We will explain the key factors that help you determine how much funding to raise. We will then outline financing options, ranging from philanthropy to debt and equity, and explain when each is suitable. Finally we offer some suggestions on how to choose the best financing option for yourself.

To help you with the investor negotiations, we also provide sample **term sheets** (non-legally binding summary sheets that describe the key features of your financing offer) that you and your advisors can fill in based on which type of finance you select. These are provided online alongside this Module and can be used in negotiations with potential investors. Please see our 'Guide to Term Sheets' which is also part of this Module 7, which will explain how to use these tools.

Please note that you will still need the services of a finance and legal professional to guide you through this process. Our Toolkit can provide you with some core concepts and guidelines but raising capital is too complex to be able to rely on our materials alone. Any financing offer will need to be tailored to the specifics of your particular venture and also the market conditions in which you are raising funds.

SolaRise Case Study



Throughout this Toolkit, we use the fictional example of a social enterprise called ‘SolaRise’ to illustrate how to raise social investment. SolaRise is a social business selling ‘Solar Kits’ in remote rural villages in regions such as sub-Saharan Africa, Latin America and South East Asia that are not connected to an electric power grid. The Solar Kit comprises a solar panel that can be installed on the roof of a rural house, connected to a battery as well as a set of solar lights. The panel and battery store enough energy during the day to be able to run up to 6 high quality LED lights, as well as charging devices such as a mobile phone or a fan.

The Solarise Solar Kit has tremendous social impact in terms of saving costs for rural households without access to grid electricity, as well as providing better lighting and useful services such as mobile phone charging. Once installed, a rural household no longer needs to spend money on expensive and polluting fuels such as kerosene for lighting.

In this Module, we will see how SolaRise decide how much finance to raise, what kind of finance and on what terms.

How Much External Finance Should You Raise?

How much finance you should raise is a delicate act of judgement. The more finance that you raise, the faster you can grow and the less you have to worry about potential cash shortfalls. On the other hand, finance comes at a cost: unless you raise only donations and grants, you will either to have to sell shares (i.e. equity) in your company, or borrow debt that must be repaid with interest. You therefore shouldn't raise too much finance too soon. Ideally you should aim to raise enough finance to get you comfortably to your next major 'funding milestone' (which we explain below), when you will be able to raise more funds on better terms.

Finance is not usually a single one-time act, but comes in successive increasing rounds of funding, usually spaced several years apart, as you can usually raise finance on better and better terms as the company grows and becomes more established.

The amount of funding you should raise also depends on investor conditions at the time. Investor sentiment can be very volatile. If investor funds are readily available, then it may be worth raising more in order to take advantage of a strong supply of funds. Your corporate finance advisor will advise you on market conditions and whether it is better to seize current opportunities, or to wait for a better time.

Funding Milestones

A key concept to help you decide how much funding to seek is the idea of 'funding milestones'.

In our booklet 'Investment Fundamentals' we describe the 'life-cycle' of a venture. We described how ventures go through several stages of development, which typically include a 'Pilot', 'Minimum Viable Product', 'Launch' and 'Growth' phase (please read 'Investment Fundamentals' for detailed descriptions of each stage).

Each of these stages is often marked out by a specific 'milestone' – a moment which marks the successful completion of that stage. The Pilot stage, for example, is often marked by the successful completion of a pilot study, often with a report indicating the results of the pilot study.

The Launch phase is marked by the moment when you begin making your first sales to customers and/or serving beneficiaries.

Stages may be further be broken down into smaller milestones. This might be having a finished working product, for example, or making the first customer sale. It might be landing the first large customer order, or securing a major supply contract. The milestones that you pick will be specific to your venture.

Some common milestones are:

- Successfully completing a Pilot
- Launching a 'Minimum Viable Product' and getting the first feedback from users
- Publication of an independent third-party study showing the social impact of your venture
- Achieving the first customer sale
- Signing a major contract (perhaps with a distributor, supplier, or major customer)
- Achieving 'break-even' (the point at which revenues is able to cover all costs)

Each milestone represents either a strong step-up in service delivery, or a significant reduction in risk for the venture, or both. Raising funds is therefore about asking for enough funding to help you get to a particular milestone. With each milestone that you cross, you should be able to go back to investors for more funding on better terms.

A particularly important milestone is the moment when your venture generates sufficient sales to cover all of its costs including overhead. This is called the **'break-even threshold'**. The break-even threshold is important because it is the moment that your venture is no longer dependent on external financing in order to survive. It is the point where raising external financing becomes a choice, not a necessity. It is also the moment from which you start to generate surplus funds that could be used to repay investment. Investors will therefore be very focused on how quickly you can reach break-even, and funding through to break-even is a common milestone.

Note that raising funds should not be more frequent than every 2–3 years, as it is a time-consuming and laborious process. You should therefore only pick the most significant milestone(s) in any 3-year period.

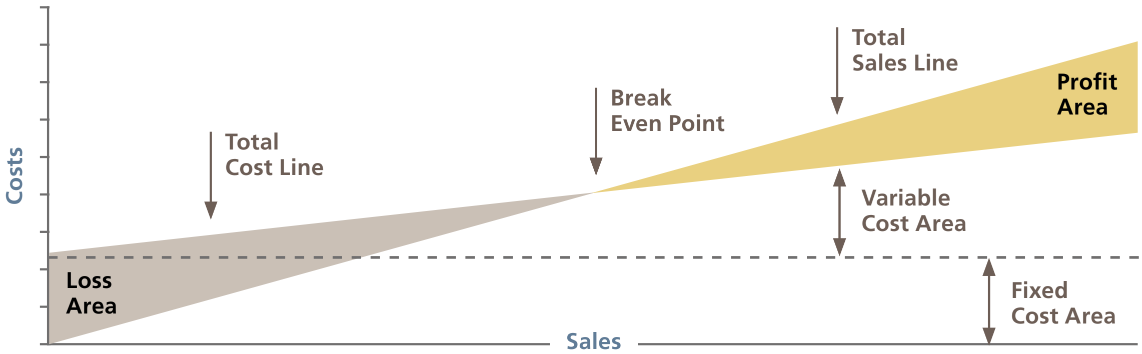
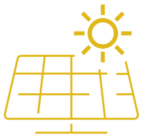


Diagram of break-even represents sales $ achieved per output of transactions. Costs are shown on the vertical axis and sales volume on the horizontal axis



Case Study: SolaRise's Funding Milestones

Let's see how SolaRise can use funding milestones to work out how much it should ask investors for.

SolaRise is a start-up that has only just completed their pilot and market study, which confirms that there is both a need and a demand for their product. They are now ready to launch.

When the SolaRise team consider key objectives and mile-stones over the next 5 years, they come up with the following roadmap:

Milestone 1: Buy and refurbish warehouse / complete set up costs (Months 0–6)
Their priority in the first six months is to buy and refurbish a central warehouse where SolaRise can store and finish assembly of the Solar Kits which are shipped in from China (where Solar Panels are made). A site has been identified and an offer made. As soon as the site is up and running, sales can begin. It costs $150,000 to buy the site.

SolaRise also needs to file the patent on its Solar Kit design, as well as install a updated IT system so that it can manage sales and inventory. The total launch costs including the warehouse will come to $220,000. These can be seen in the SolaRise Financial Model (Module 5) under 'Capital expenditure' on the 'Costs' Sheet.

Buying the warehouse and completing the set up costs could therefore be the first milestone for SolaRise. A finished warehouse would mean that SolaRise could start to sell.

Amount needed: $220,000
Purpose: Capital expenditure (buy warehouse, complete IT systems, secure patent)

Milestone 2: Start Sales (Months 6–18)
Sales can begin as soon as the warehouse is up and running. Initially sales will be made by direct selling to local stores. They hope to use this period to establish customer relationships, begin building market awareness of the product, and also confirm that their price point at $200 has market acceptance.

During this time, sales will not be enough to cover operating costs so SolaRise will be using up cash during this time. SolaRise estimates it could be spending up to $20,000 every month during this phase, which may last the first 18 months.

Amount needed: $20,000 × 18 months = $360,000
Purpose: To maintain operations while sales are ramping up

Milestone 3: Sign contract with a major distribution partner (Month 18–24)
To accelerate sales, SolaRise know that they won't be able simply to sell store-by-store. They need to sign up a large retailer that owns multiple stores near the areas where they wish to sell. Once customer sales have therefore been proven on the initial local stores, SolaRise plans to negotiate a large contract with at least one major retailer. If this happens, sales could at least double, helping them reach their target of selling 6,000 units sold in year 2 and 10,000 units in year 3. During this time, SolaRise will still be using up cash as sales will not be sufficient to cover costs. They continue to estimate a 'monthly cash burn' rate of $20,000 to be conservative, but hope that more cash from sales will be coming in to off-set this. Nevertheless to be conservative they do not assume significant sales revenue.

Amount needed: $20,000 x 6 months = $120,000
Purpose: To maintain operations while sales still ramping up

Milestone 4: Breakeven (Months 24–36)
If SolaRise is able to achieve the above milestones, they estimate they could reach break-even sales of close to 10,000 units per year by year 3. This would be a significant milestone for SolaRise. This is when they could cover all of their operating costs, including overhead, from sales alone and would no longer be reliant on external finance. They might even be able to begin repaying investors, or raise more investment to accelerate growth even faster.

In order to reach breakeven by month 36 at the latest, SolaRise estimate they would be using up $5,000 of cash each month in the final 12 months before breakeven. During this time revenues should be picking up, and they are now comfortable to begin factoring some sales revenue into their estimate.

Amount needed: $5,000 x 12 months = $60,000
Purpose: To maintain operations until sales reach break-even

Milestone 5: Expand through Franchising (Months 36–60)
By year 5, SolaRise estimates that if all goes well, they will be in a position to expand to other regions and possibly even other countries. You may recall that in Module 4 ('Scaling Strategy') our team decided that one option for scaling would be to for SolaRise to 'franchise' its business model to entrepreneurs in other regions. These franchisees would then sell under the SolaRise brand. SolaRise would then be funded through franchise fees and product sales to other local franchisees. SolaRise will explore this option when they reach that stage, but milestone 5 would be signing up the first franchisee.

To set up the Venture to become a franchise operation, SolaRise estimate that they would have to spend $300,000 to adapt their operations. This would include developing a franchise manual and template franchise agreements as well as marketing efforts to recruit franchisees (partners in other regions willing to adopt the SolaRise brand). This cost would also include setting up a dedicated franchise team to work on the franchise (sales, marketing and franchisee support). In other words, this would be a new round of capital expenditure to help boost SolaRise's sales to another level.

Amount needed: $300,000
Funding need: Capital expenditure

Which milestone should SolaRise pick?

SolaRise could pick any one of these milestones as being the one to raise funds for, and pitch to investors.

Which one should they pick?

1 **Buy Warehouse & set up**
Funding needed: $220,000
Months: 0–6

2 **Start Sales**
Funding needed: $360,000
Months: 6–18

3 **Sign Major Distributor**
Funding needed: $120,000
Months: 18–24

4 **Reach Breakeven Sales**
Funding needed: $60,000
Months: 24–36

5 **Sign Franchising Agreement**
Funding needed: $300,000
Months: 36–60

Total
$1,060,000

Before we give you the answer, you may wish to consider which milestone you would go for.

You should consider these points:

- SolaRise doesn't want to come back to investors for at least 2 years because the process of raising investment is very time consuming.
- They estimate that the maximum amount of funding that they can raise in this round is $1mn. They are simply too early stage and lack the track record to be able to attract a larger sum of investment at this stage.
- The more investment they raise, the more expensive it will be (either in terms of equity ownership given up, or the interest rate on any loan).

SolaRise decide to pick option 4 – breakeven – as the milestone to aim to raise external funds.

Their thinking is as follows:

- Since they don't wish to come back to investors for more funding for at least 2 years, just raising enough funds to complete milestones 1 and 2 will not buy them enough time before they have to revert to investors for more funds.
- They could raise funds to get to milestone 3 (signing a major distributor). This would require raising $700,000 (the sum of the funding needed for each of the first 3 milestones). This is a reasonable sum.
- However it would require only a further $60,000 to reach break-even. This would still be comfortably within their maximum threshold of $1mn, and would mean that they would be in a much more comfortable position of not being reliant on external funders thereafter.
- Raising funding all the way to milestone 5 is too much. The total capital requirement would be above $1mn, the maximum amount that they think they can raise in this round. Moreover, even if they were to raise this total level of finance, investors would charge a very high price for backing a proposition as risky as franchising an unproven business model. Far better to reach breakeven first, and then approach investors for a new round once the business has more track record.
- Raising $760,000 to get to the end of milestone 4 is a good compromise. In fact, SolaRise will seek $850,000 to provide a good margin of safety. The amount is not close to the maximum limit of $1mn which they think the market could provide, nor likely to be too expensive as SolaRise will not be asking investors to take risk on a speculative project (i.e. franchising an unproven business model). Moreover, if SolaRise can reach breakeven, they will not have to approach investors again, unless they wish to for faster expansion. They will therefore be able to approach investors from a position of strength in the next round.
- SolaRise therefore decide to seek $850,000 of external funds in this round of investment.

Exercise:

What Are Your Funding Milestones?

Now let's see if we can apply this approach to your own social venture.

Please write down potential key funding milestones for your venture over the next 3–5 years.
– What are the critical achievements that would signify a big step-up in the growth potential of your venture?

For example:
– Could an independent study from a leading university confirm the social impact that you are creating?
– Are there key markets that you would like to launch, or key customers/beneficiaries to approach?
– Are their moments that signify product acceptance and/or uptake?
– Are there key supplier contracts to land or major distribution partners to be secured?
– Do you need to build a factory or manufacturing facility? Do you need to obtain a patent or license?

For each potential milestone, please set out a time-line and a cost estimate for how much it would take to get to each milestone, in a similar way to how SolaRise did it in the above example.

Keep the milestones to no more than the 3–5 most important. Which one would you pick as the most significant for your business, that you could raise finance towards?

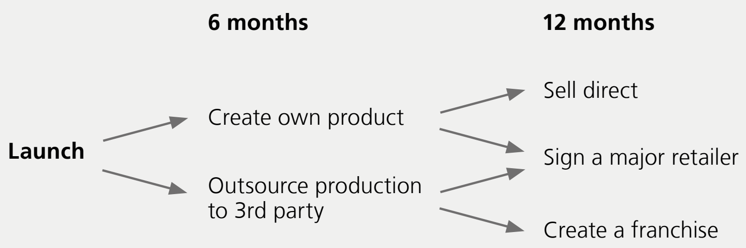
Exercise:

Defining a Growth Path with Choices

This exercise is a a more advanced version of the Funding Milestone approach, which is called Growth Paths. A growth path represents milestones as a decision tree, with different choices depending on how you might wish to grow your venture. For example, early on you may have a choice between making your own product or outsourcing production to a third party.

Each choice will have different consequences in terms of cost, ease, and likelihood of success. By laying these out in a diagram you can show investors the possible options that your venture has, and even enter into a dialogue about which path they may be willing to fund.

Investors like to see you thinking through alternatives, and being flexible as to which one might succeed. A growth path might look as follows:

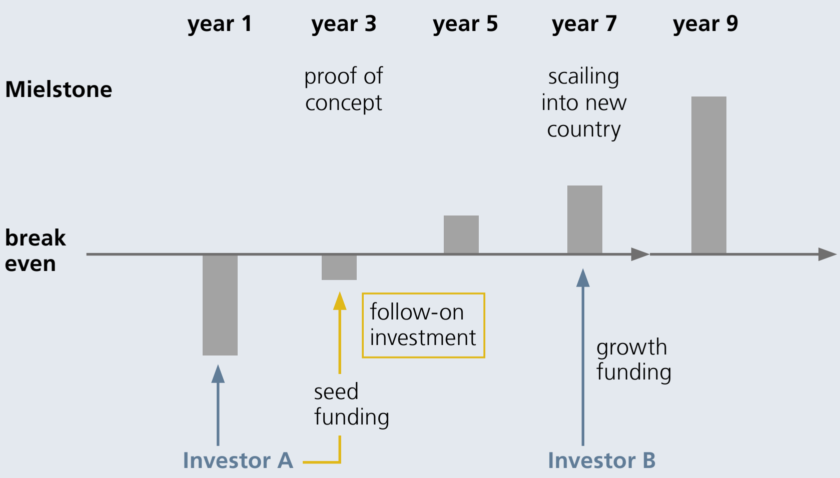


The milestones here are set out like stepping stones with multiple options. Should you create your own product, or outsource production to a third party? Should you try to sell direct, or seek to distribute through a major retailer? If you can identify those choices, and then put a cost estimate and effort assessment (how easy would it be to achieve that milestone?) behind each one, you can then have a conversation with investors about which growth path to try, and what the cost would be.

As an exercise, please try this for yourself. What are the possible ways that you might be able to expand over the next 36 months? Can you set out various discrete options and lay them out as a growth path with a decision tree?

Investor Tip

Following on
Equity investors rarely invest all of their funding into a venture in one go. Instead they use milestone funding as a way for them to manage their risk. They decide how much they will invest in you in total over five years, but only invest these amounts in your business in stages based on your achieving the pre-agreed milestones. This is known as 'following on'. Often, the best source of future investment are existing investors who follow on with you through several rounds of finance, as they already know you and have a long-standing knowledge of the business.



You should spell out for investors what the key development milestones are for your business over the next 3–5 years, and lay out a funding path overlaid on top of the milestones (i.e. when you will come back to them for more funding). You should ask investors to fund you through to the next major milestone, after which you may return for more money having demonstrated success. If it takes you longer than expected to achieve a milestone, you may have to go back for more funding, but you can then explain what caused the delay. Investors will then take a view as to whether to put in more funds or to step back.

When you raise a new round of finance, the first people that you should approach are the people who already backed you in your previous round. Can they add in more funds now that the venture is more established? They may be able to recommend you to other investors. The most credible source of recommendation for new investors are current investors who are willing to follow on a prior investment.

Investor Tip

Calculating Your Monthly Cash Burn Rate
One very useful figure to provide to investors is your monthly 'cash burn rate'. This is simply how much expenditure you incur on average to keep going every month. It will mainly consist of all of your monthly salaries, together with fixed expenditure such as rent, insurance, utility bills, travel (all averaged out into a per month figure). The more staff that you add, the higher your cash burn rate will be. The cash burn rate does not include off-setting revenues that you might be earning per month. The idea is that if you suddenly stopped making any sales, how quickly would your bank account start to empty each month? The time left before you reach zero is known as your 'runway'.

When calculating the cash burn rate, you should only include core costs that would be expended regardless of sales. Don't include any costs relating to product or service delivery, such as raw materials or shipping. Nor include any labour costs that are contractors that you don't need to pay if there is no sale. The monthly cash burn rate is intended to answer the question: if the venture stopped receiving further cash tomorrow, how long could it survive?

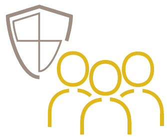
Generally speaking, you should aspire to always have enough cash in the bank so as to give you a runway of at least 6 months.

What Are Your Financing Options?

Once you have quantified how much funding you need to raise, you are then ready to decide which funding option to choose. Social innovators have access to three basic kinds of finance: philanthropy, equity and debt. All three are very different types of investor:

- **Philanthropists** care solely about the social impact they will create by donating to your venture. They don't care about financial return or getting their money back. They will be focused on how you will create positive social or environmental impact and how you will measure this (as discussed in Modules 1 and 2).

- **Equity** investors buy ownership in your business. They want both financial return as well as social impact. They will ultimately hope to get a financial return by selling their shares to future shareholders at a higher share price than they originally paid. They therefore care about your growth prospects as well as the long term profitability of your venture, which will determine the future value of their shares. Equity investors are usually willing to take more risk than debt investors, but will be expect to share in the upside of any future growth.



- **Debt** investors lend you money which must be repaid from the company's future profits. Their financial return is capped at the interest rate. Lenders are therefore less concerned about the long term value of the company as long as you generate enough profit to repay the loan. They usually care more about protecting their loan and minimising any risks that might jeopardise your ability to repay. Lenders look for protections in the form of **security** (assets that can be sold to repay the loan) and covenants (rules governing what you can do).

Let's look at each of these more closely to see which might best apply in your case.

Philanthropy

Philanthropy comes in two main forms: grants or donations.

- **Grants** usually come from an institution such as a government body or a foundation. Grants may be 'restricted' (i.e. come with strings attached in terms of what you can do with the funds) or 'unrestricted' (i.e. may be used for general purposes, including salaries and overhead).

- **Donations** are gifts from members of the public, often as part of a public fundraising campaign. Donations are usually for general purpose.

For many social ventures, philanthropy is the default funding option. Firstly, many social ventures don't have a commercial business model. In other words, they don't sell goods or services in order to fulfil their social mission. For such ventures, the choice is clear: if they need to raise external finance, they can only raise philanthropy. The other forms of investment all require a commercial business model, since they all require repayment of capital from earned revenue.

Secondly, if you are incorporated as a non-profit legal entity, you will not be able to raise equity (since non-profits do not have shareholders and so cannot issues shares). Unless a non-profit is willing to raise debt (which carries the risk of bankruptcy), philanthropy is also the only option in this case. We discuss this at length in Module 6 ('Legal Structure').

That leaves a much smaller group of social ventures fortunate enough to be able to choose between philanthropy, debt and equity. How do they decide?

Even those social ventures that do have a commercial business model often start out with some grant funding. It is the cheapest and often easiest source of initial start-up funding for socially mission driven organisations. However, the supply of grant funding is limited, unpredictable and very hard to keep coming year after year. It is very laborious to continuously raise and manage grants. Unless your organisation's capital needs can be met with easily just from grants and donations, you may need to diversify into commercial sources of funding – i.e. debt and equity, once your operations are more established and ready to scale up.

We generally recommend that social ventures raise their earliest funding from grants and donations if it is relatively easy to do so because it is the cheapest form of funding. Be careful though that you don't take on a series of onerous conditions with each grant that prevent you from implementing your social mission in the way that you wish. Grants often come with strings attached, based on the donor's own requirements, which may be a distraction or take you off track. Avoid the trap of doing work that isn't part of your mission just for the money.

Once your venture reaches a certain size, continuing to fund it through grants and donations becomes increasingly more difficult. Grants often last only a year or two before you have to find a new donor, leaving even established organisations constantly exposed to the risk that a grant funder may suddenly withdraw or cease to renew. 'Donor fatigue' is a frequent problem. Even if you raise grants, you should be examining the alternatives in case you eventually outgrow the capacity of the philanthropic sector.

Summary:
Choose Philanthropy if any of the following are true:
- You don't operate a commercial business model selling goods and services
- You are legally unable or unwilling to raise other forms of investment
- Grants and donations are sufficient for all your capital needs
- Your social venture has not yet launched and you need some grants to get going;
- You are unwilling to give up ownership (equity) or borrow debt
- You do not expect to generate enough profits in future to be able to repay investment

Equity

Types of equity

Equity is the most common way for early stage ventures to raise external finance. Raising equity involves selling a percentage of your company (as shares) to outside investors. Shares in a venture give the shareholder the rights to their proportional part of the venture's distributable profits, through payment of 'dividends'. It is important to note that the venture is under no obligation to pay out dividends. Most early stage ventures don't pay dividends as they need to reinvest all available cash for growth. Payment of dividends to Ordinary Shareholders is normally barred for as long as there are any other form of investment outstanding.

Equity is therefore a safer form of capital for ventures to raise than debt because dividends are only paid if the company has the profits to pay them, whereas interest must always be paid – regardless of profits earned. Also, shareholders are always paid last in any pay out (such as if the company were to be sold or liquidated), behind all other creditors of the company, including debt providers. For this reason, equity is often the only form of capital that is suitable for early stage, high growth companies.

As a result, equity investors usually expect a higher return on their investment than debt investors because they are taking higher risk and waiting longer for any payback.

Equity investors therefore tend only to invest in companies that they think have excellent growth prospects, where they can receive a multiple of their original investment back. A commercial venture capitalist would be looking for a financial return of at least 5 – 10x their original investment, for example.

Social investors may be able to accept a much lower rate of return, but many will still be hoping to sell their shares at 2–3x their original investment eventually, or more. While this may appear high, please bear in mind most equity investments in early stage companies fail within 5 years and the investment will be completely written off. Many investors need to price in this high risk by seeking a higher potential financial return.

Ordinary and Preferred Shares

There are two kinds of shares which are known as Ordinary Shares and Preferred Shares:

Ordinary shares are the shares awarded to founders, senior staff and sometimes the very earliest investors in a company, often at the 'friends and family' stage. Ordinary shares get paid last in any pay-out or profit distribution, behind Preferred Shareholders and all other creditors of the company. Usually dividends are barred from being paid to Ordinary Shares altogether for as long as the company has Preferred Shareholders. Ordinary Shareholders may therefore have to wait a long time before they are entitled to receive any dividends on their shares.

Preferred shares is the type of shares normally issued to new investors in a company. As their name implies, they rank ahead of ordinary shares in the event of any pay-out to shareholders (such as if the company was bought). They may also have special voting rights and veto rights above the Ordinary Shares, giving them greater control over major decisions such as whether to issue more equity, to raise debt, or to sell the company or merge with another.

Preferred Shares are in fact a form of permanent loan that converts into Ordinary Shares at the option of the Preferred Shareholder (or upon the incurrence of a special event such as the company being listed on a stock exchange). As such, each Preferred Share specifies a 'conversion rate' which specifies how many Ordinary Shares the Preferred Share may be swapped for. Despite this, Preferred Shareholders still have shareholder voting rights as if their shares had already converted into Ordinary Shares.

Preferred Shares often have a regular payment, called a 'coupon', which works a lot like the interest rate on a loan. This is a fixed annual percentage rate of the Preferred Share amount which is repaid to the Preferred Shareholder periodically (say annually or semi-annually). The difference with a loan interest is that the Coupon is usually only paid if the company has earned enough 'distributable profits' to be able to make a payment. If the company doesn't have enough profits to make a payment, then the coupon rolls over into the next period.

Valuation

Since raising equity is about selling ownership in a company, a key point of discussion with equity investors will be what the company is worth. This is known as its 'Valuation'. Valuing a company is a very subjective business, and will be a matter of negotiation between you and the investors. Typically you will want as high a valuation as possible, while investors will prefer a lower valuation (i.e. to buy shares more cheaply).

In Module 5 ('Financial Model') we discuss some valuation methodologies, and explain a method called 'Discounted Cash Flow' which is often used. At the end of the day though, a company is only worth what investors are willing to pay for it. This will depend on many factors beyond just your expected future cash flow, and will include:

– Your social impact, and the extent to which social investors will give you a higher valuation because of the impact that you are creating

– Market conditions, including the availability of equity finance in your country/sector for projects of your type.

– The maturity of your venture. The valuation of early stage, rapidly growing ventures will be changing rapidly and it may be unwise or expensive to lock in a valuation too early.

We recommend engaging a professional corporate finance advisor to help you value your venture.

If you are unable or unwilling to agree a Valuation (perhaps because your venture is too early stage and any valuation would be too low at this point in time), a common way to resolve this is by issuing a **Convertible Loan.** This is a loan that converts into equity at a future date. It essentially pushes out the discussion on what your company's share price should be until such time as the company is more advanced.

Exit

'Exit' is the term for how equity investors expect to get their financial return. Most equity investors will plan to exit by eventually selling their shares to someone else. For institutional investors such as funds, they usually need to sell their shares within 4–7 years, and may require your entire venture to be put up for sale at that time so that they can find a buyer. You need to decide if you are comfortable with this before taking on this kind of investor, and to have a candid conversation with potential equity investors about what the 'exit' options are for them in due course. If you are unwilling to sell the venture in due course you should not take investment from an investor that requires this kind of exit.

Some equity investors such as foundations or private individuals may be willing to be 'buy and hold' investors who will invest in you for the long term, without requiring an eventual exit through share sale. These investors may be willing simply to be paid a regular dividend on their shares out of the company's profits, or to have their shares bought back by the company at some stage in future. You need to understand which kind of investor you are dealing with and what their expectations are.

The 3 critical questions you should ask every investor are:

– **When** do they plan to exit? (do they require a company sale at that point?)
– **How** do they plan to exit? (i.e. via share sale, dividends, or share buy-back?)
– **What level of financial return** are they hoping to achieve when they exit?

If the investor's expectations don't match what you're willing to offer or think you can achieve, then be willing to walk away from the investment. It's very important to be clear with investors about their exit plans and financial return expectations upfront, to avoid any misunderstandings.

Sharing Ownership and Control

If you take on equity, you are essentially inviting a co-owner into your venture alongside yourself. This means giving up some degree of control, depending on how much ownership you sell. New investors will have 'shareholder voting rights' which will be proportional to the shares they own. This means they will be able to vote their ownership percentage in any shareholder vote. There may also be some special shareholder decisions (such as whether to sell the business or merge with another venture) that may require a super-majority of shareholders (e.g. 75%) to approve, giving minority shareholders greater influence or even veto.

Some shareholders may require a seat on your board, which will give them extra oversight and control.

Before taking on new equity investors, you need to decide how comfortable you are with giving up some ownership/control, whether you would be willing to offer board seats to your largest investors, and how much ownership you would be willing to give up in exchange for funds.

You also need to be very comfortable with the investor themselves and make sure that are someone that you would be happy to work with, and whose vision and values are aligned with yours. We recommend that you think of any new equity investor as a business partner. Never accept investment just for the money.

Summary: Choose equity if:
- You are a for-profit legal entity with a commercial business model
- You need to raise external funds to finance growth
- You are willing to give up some degree of ownership/control in your venture
- You are willing to take on additional owners of the business
- You could envisage eventually selling the business, or buying back the shares from the new investors using the company's future profits.

Debt

Debt for social ventures is typically in the form of a loan from a bank, fund, or direct from wealthy individuals ('angel investors'). Unlike equity, debt does not require giving up ownership in your company. Debt is repaid from the cash flows of the company, together with interest, within a specified timeframe (the 'maturity' of the loan) and according to a specified repayment schedule.

If you cannot meet the scheduled payment of interest or principal, you 'default' on the loan, which has the consequence that the loan investor can call in the loan and bring about a bankruptcy of your company. Usually there is a period of negotiation and potentially loan re-scheduling and other remedial actions taken before bankruptcy occurs, but if it occurs, it is fatal for the company: the company will be liquidated, its assets sold, and the cash used to repay the loan back first, to the extent that there are any funds left.

Raising debt is therefore riskier for the enterprise than equity. With equity, you cannot default – if you have no profits in a given year, then no dividends need to be paid out. In addition, you do not need to repay an equity investment like you repay a loan; an equity investor gets their money back not from the company but from a future investor who buys their shares in the venture.

Debt, on the other hand, requires repayment whether you have profits or not, and the price of non-payment is bankruptcy. Since debt is riskier in this sense, it is more suitable for more mature companies that have achieved some stability of cash flow, and can be confident in their abilities to generate income to repay loans.

Normally, only companies that are already generating positive, stable cash flow can raise a long term loan (i.e. longer than 1 year). Lenders require seeing some proven track record and will typically only lenders to companies that are already operating for several years and already profitable.

The exception to this are **start-up loans** made to a business in its early stages (i.e. 'seed round' and earlier). These loans often come with an option to convert into equity at a later stage. Loans with this option are known as **'Convertible Loans'**. This is a common method of providing start-up capital. In the early rounds of investment, it may be difficult to put a value on the company. A convertible loan enables the investor to invest now, but take shares in the company at a later stage when the company has a more solid track record and a more accurate valuation is possible. The loan typically converts at a discount to any new share price in order to reward the loan investors for having taken earlier risk on the company (in other words, the loan investor may get to switch their loans into shares at a lower share price than new investors would pay).

Summary: Choose debt if:
- You have assets that you can pledge as security (e.g. buildings, receivables) and/or
- Your venture already has a track record of stable, positive cash flow or
- You are an early stage for-profit venture looking for a (convertible) start-up loan

Working Capital Facility

There is one special form of debt that we wish to mention known as a **Working Capital Facility** (also known as a 'revolving line of credit'). The most common form of this is a bank overdraft. A working capital facility is designed to help smooth temporary shortfalls in cash that you might have, similar to how a credit card works for individuals. For example, a manufacturing business may build products 6 months prior to receiving cash from sales. This creates a short-term cash drain, which needs to be financed. Many businesses that have a long lag time between expenditure and sales are like this. A working capital facility enables the business to draw down funds to meet the shortfall, which can be repaid once revenues are received.

Working capital facilities can be arranged with banks, and will generally have commercial rates of interest. Some foundations are also starting to offer this type of financing, generally with more favourable rates. Working capital facilities can be drawn down up to a specified limit and repaid repeatedly during the course of a year (a feature known as a 'revolver'). Interest is charged on the amount drawn, just like a credit card. A working capital facility must be fully repaid by the end of one year. It is not designed as a long-term source of financing, but only to help smooth cash flow needs. This can be very important for businesses that would otherwise need to hold large amounts of cash in reserve.

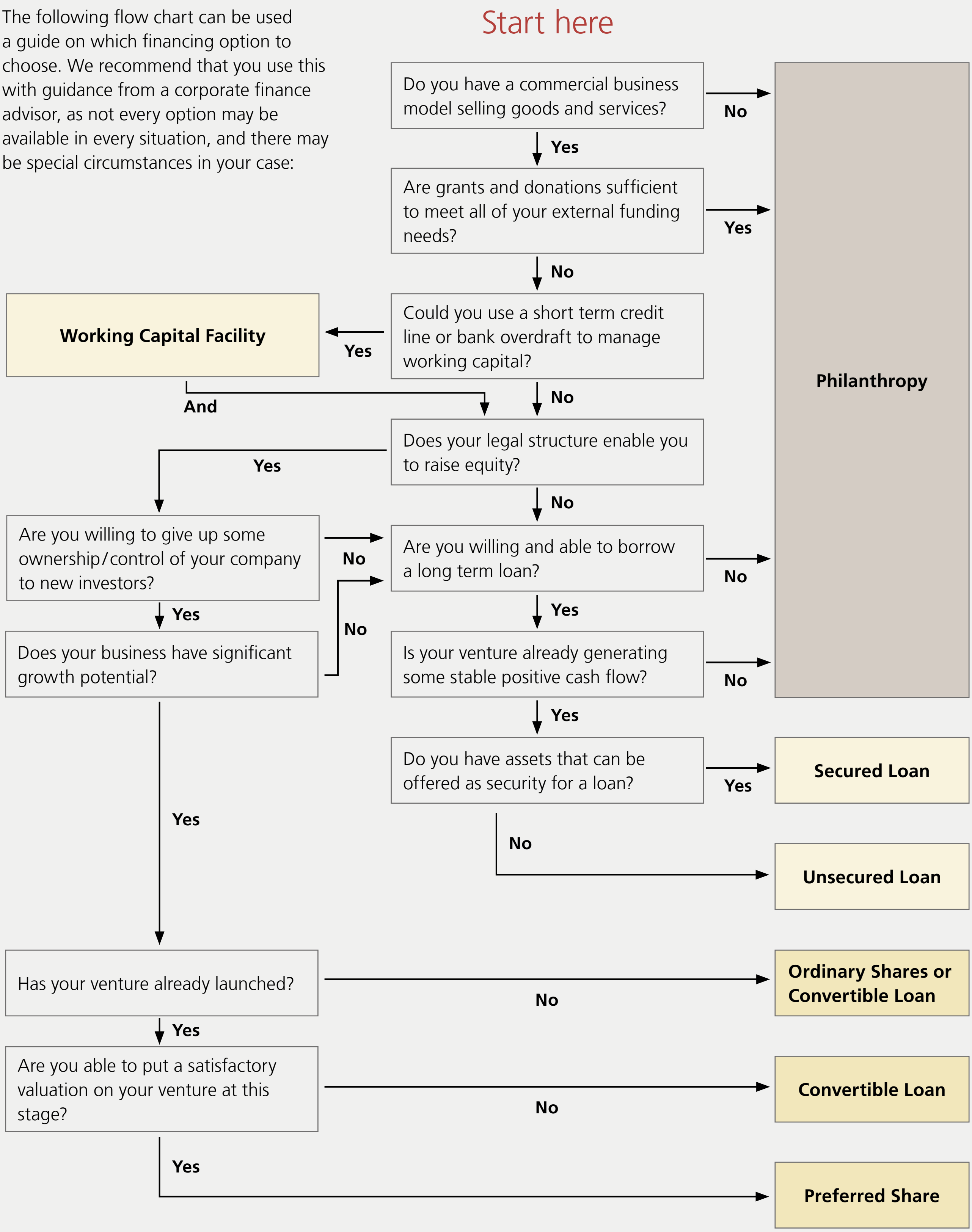
Many businesses fail not because they are not profitable, but because they temporarily run out of cash. A working capital facility can help prevent this.

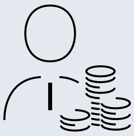
A working capital facility is compatible with any of the forms of finance mentioned above, and can complement any investment strategy, at any stage of your venture post-launch.

Summary: Choose a working capital facility if:
– There is a long delay between when you begin incurring expenses for a product and when you finally receive the cash from your customers

Exercise: Which Finance Option Should You Choose?

The following flow chart can be used a guide on which financing option to choose. We recommend that you use this with guidance from a corporate finance advisor, as not every option may be available in every situation, and there may be special circumstances in your case:





Investor Recap

- This Module has hopefully helped you to work out how much investment you wish to raise, what kind of investment (debt, equity or philanthropy) and how to think of about some of the key terms of that investment.

- You can use 'funding milestones' to work out how much investment to raise. You should aim to raise enough investment to comfortably get to the next major funding milestone. You don't wish to raise funds more frequently than every 24 months, so pick meaningful milestones that will significantly improve your ability to raise funds on better terms once you've passed them. Let investors know what you consider to be the key funding milestones, so that you can set their expectations on when you might come back to them for more funding, and for what reasons.

- You may wish to set out a 'milestone map' showing different alternative growth paths that you might take, along with the funding needed to pursue each path. In this way you can engage in a dialogue with investors about the right mix of funding and growth that you wish to achieve. Particularly for equity investors, the more that you can engage your investors in your growth plans and solicit their buy-in and input, the better. You may be surprised to find that some investors would be willing to give you more now in order to help you grow faster and be more ambitious in your growth targets.

- Breakeven is a particularly significant milestone because it is the point at which you don't need to come back to investors for more funding. Also remember to calculate your monthly 'cash burn' rate: don't raise less than at least 6 months of runway so that you have time to grow between fundraising rounds.

- Remember that your current investors are also your most likely source of future investment, so it's very important to both keep your investors informed of your progress towards achieving your milestones, as well as to prepare them in advance for when you might wish to come back for the next round of funds. Current investors are also the best recruiter of new investors, so you must keep good relations with your investors to help secure their support in future rounds.

- Philanthropy is very useful when you're starting out as a social venture. However for larger amounts of funding as well as long-term sustainability, you are likely to need to switch to more commercial funding (i.e. debt and equity) once you reach a particular size. This is true only if you operate a commercial business model (i.e. sell goods and services). If you don't operate a commercial model, then philanthropy may be your only option.

- Equity is very suitable for rapidly growing businesses with excellent profit potential. If you raise equity, you must be willing to give up some ownership and therefore control over your business, and possibly even willing to put up the whole business for sale in future. If you're not comfortable with this, raising equity may not be a good option for you. You should be upfront with potential equity investors about degree to which you are willing longer term to give up ownership, and also what the 'exit' options for the investor might be.

- Social Investors may use the Valuation as one of the main means to build social impact incentives into the deal structure. For example, a social investor may be willing to accept a higher valuation than a purely commercial investor because of the great social impact that you are delivering. We have also seen deals where the 'conversion rate' on the Preferred share (i.e. the number of Ordinary Shares into which each Preferred Share converts) varied depending on whether certain social impact metrics were achieved. This can be quite an elegant way to incentivise the social venture to achieve pre-defined impact targets.

- Long term Debt (i.e. a loan) is really only suitable for more mature businesses that already have a proven track record and some degree of certainty of stable cash flow. Loans are more risky for ventures because failure to repay a loan on time can result in bankruptcy. Some ventures are able to raise loans with 'flexible repayment profiles', where the loan payment is only made if the venture has the cash to be able to pay. Otherwise the loan instalment rolls over into the next period. However these kinds of loans are less frequently offered than fixed instalment loans, and you will need to find an investor willing to fund in this way.

- Social Investors can build incentive mechanisms for social impact into Loan Agreements as well. You may even wish to ask for this directly. Two common ways to do this are through the interest rate (i.e. the interest rate could fall if certain impact metrics were reached) or through the repayment profile of the loan (i.e. you have more time to repay if the venture achieves its impact targets).

- Whichever kind of venture you run, getting a 'working capital facility' or bank overdraft can be very useful in helping you manage short term cash fluctuations due to the timing of payments.

- A start up loan is the exception to the rule that only mature ventures can raise debt. Start-up loans often come with a convertibility option where they can convert in equity in a later round of investment. You should offer this option to investors if you're not ready or willing to place a valuation on your company because you are too early stage. This can be a useful way to unlock seed funding without having to get into a negotiation over valuation too early.

- In this Module we provide a sample Term Sheet for an equity investment in the form of a Preferred Share. We also provide a Sample Term Sheet for a Loan. Please see the booklet 'Guide to Using Term Sheets' to explain more about these documents and how to use them.

- In the next and final Module in this Social Investment Toolkit, Module 8 ('Approaching Investors'), we explain how to approach investors once you have a Term Sheet ready.

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