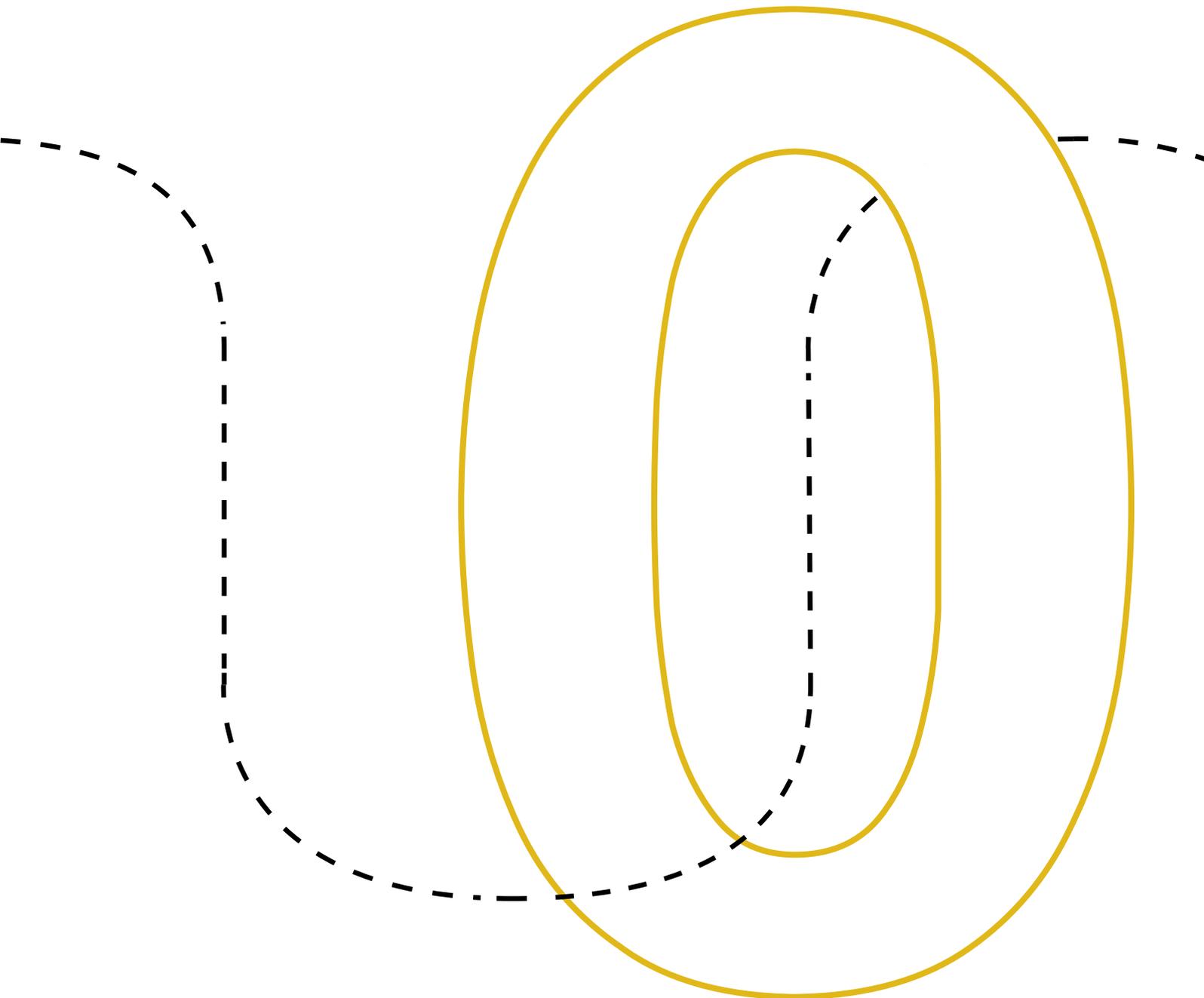


Social Investment Fundamentals

Social Investment Toolkit | Pre-Module



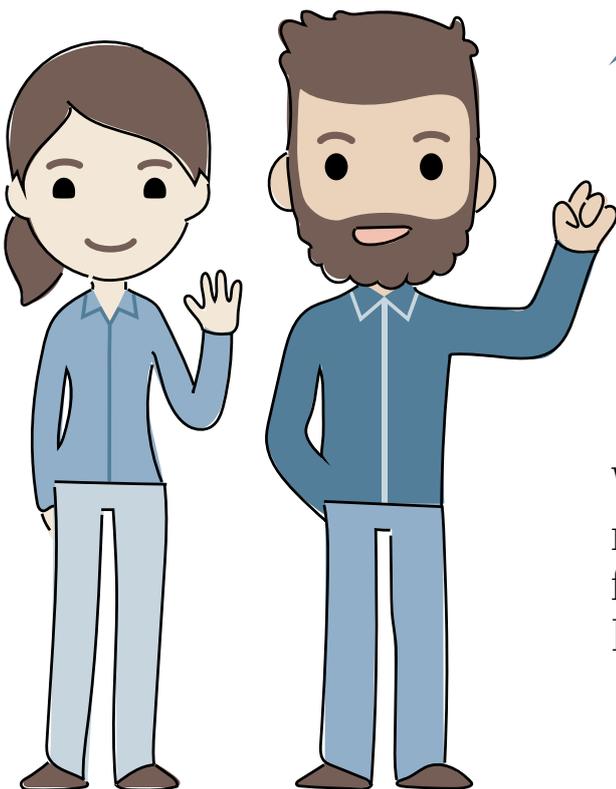
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Before we start the individual modules in this toolkit, we offer below a short introduction to some foundational concepts in finance that will help you throughout the rest of this toolkit.

In this pre-module, we cover:

- The Life-Cycle of a Venture
- Stages of Finance
- Three basic financing options: philanthropy, debt and equity



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

Life cycle of a venture

Every venture goes through several stages in its development. Some of the typical milestones / stages which ventures mark out might include:

1. Pilot stage

- Prove the concept: develop a proto-type; complete pre-market customer/beneficiary testing, build case for impact
- Acquisition of relevant approvals, licenses etc to operate

2. Develop Minimum Viable Product

- Develop the most basic product or service that a customer will buy
- Test and iterate feedback with early customers/beneficiaries to refine into a finished product

3. Launch

- Launch finished product / service

4. Acquire first major customer(s)

- First sale to a major customer or group of customers completed
- Achievement of a certain target level of sales

5. Break-even

- Revenues sufficient to cover all costs

6. Growth

- Venture rapidly expanding sales

You might think of other critical milestones relevant for your venture. For example, your milestones might include signing up a certain customer, winning a particular contract, getting a key license, securing a patent, or getting your impact results confirmed in an independent study.

You should set out these milestones in a timeline in your business plan for investors. Seeking to raise finance immediately after achieving a key milestone will not only be easier, but will be cheaper (i.e. you will be able to raise more finance on better terms) because the venture is materially stronger and less risky with each milestone passed.

Financing stages

As ventures grow, it is normal for them to raise successive rounds of finance every 3-5 years. The type of finance raised is nearly always equity to begin with because equity is designed to be high growth, high risk capital (if this doesn't make sense yet, don't worry – we'll explain this in more detail later). Investment can transition to debt finance once the business is more mature and has the steady, predictable cash flows which debt requires. These rounds of finance follow different stages of development, as follows:



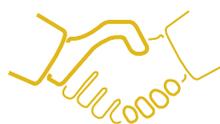
1. Bootstrap

The bootstrap phase is when your project is just an idea. You have not yet proven the concept. You are researching, developing a proto-type, perhaps beginning to work out who your customers are and what their needs are. The bootstrap phase is nearly always self-funded (e.g. in your spare time while doing a day job, from personal funds etc).



2. "Friends and Family"

The next round is commonly known as the 'friends and family round' (sometimes jokingly referred to as the 'friends, family and fools' round because only fools would be so rash as to invest in you at this point). This round is typically raised from close contacts of yours who know you well and are willing to take a very high risk. This round typically funds you through the pilot phase and to the point where you can prove your concept works and have proto-typed your product or service. For social ventures, raising some grant funding from individual philanthropists, foundations, competitions or government support funds can also be a useful form of capital at this stage.



3. Seed

The seed round takes place after your pilot. You have proven your concept, now you need funds to help you develop from prototype to a 'minimum viable product' and begin market-testing and finding early customers. You have exhausted your friends and close contacts, and now approach private investors known as 'angel investors'. Angel investors are wealthy individuals investing their own personal wealth into very early stage investments. They typically invest \$5,000 – 100,000 each and ventures normally need to raise funds from several angels for their seed round. A typical seed round might be up to \$1mn in total from up to 15 angel investors, with individual investments of between \$20-100k each. Seed rounds rarely exceed \$2.5mn in size. In contrast to venture capital and private equity funds, who fund later stages of development, the market for seed round investment is relatively undeveloped. As such your success will be driven by your personal connections and ability to find angel investors. Similar to the previous stage some grant funding may still be available to social ventures in the seed stage – either from philanthropists, foundations, or competitions. The seed round is usually too small and too high risk to be of interest to investment funds at this stage. There may be several seed rounds before you are ready for larger rounds of finance.



4. Series A, B, C...

The 'Series A' round is the first round where larger scale funding in the form of Venture Capital or Venture Philanthropy funds get involved. Venture Capital ('VC') funds are professional funds that invest in high growth, early stage ventures, and they are always on the look out for the type of early investment that will give them a big financial return later on. The best VCs generally provide more than just financial support – bringing expertise and networks to help their investee succeed. Venture philanthropists on the other hand, aren't necessarily looking for the potential of high financial return, but they take the same hands on approach to investees, and invest early stage. These are dedicated social impact funds that have been set up specifically to invest in social enterprises.

The Series A will typically be up to \$7mn, with an average of around \$5mn and a few that are larger (up to \$10mn). By this stage, you will have been operating for several years, built up a customer base and developed a proven product, and be growing rapidly. You are now able to set out a series of further growth milestones that will see you on the path to becoming a company with revenue of more than \$50mn. Given this ambition, not every company will be eligible for a Series A round. Investors will only invest these amounts if they see the potential for you to exceed \$50mn and ideally \$100mn of sales within 10 years. Later rounds of investment are known as the Series B, Series C and so on.

Name of round	Capital size	Investor	Stage
Bootstrap	<\$100k	You	Proof of concept
Friends and Family	<\$200k	Close contacts	Pilot
Seed	\$0.2 – \$2.5mn	Angel investors	Launch & early years
Series A	\$2.5 – 7mn	Venture Capital	Growth

Financing options

Social innovators have access to 3 basic kinds of finance: **philanthropy, equity** and **debt**. For any substantial amount of long-term finance, equity and debt are your strongest options. Equity and debt are very different forms of raising finance.

Equity investors are buying ownership in your business. They therefore care keenly about your growth prospects and above all the value of your company. They ultimately hope to realise a financial return by selling their shares to future investors at a profit. Equity investors are willing to take more risk, but expect greater return, through a share of the financial returns of the business, or in other words, a share of the profits.

Debt investors on the other hand are lending you money, which must be repaid from the company's future profits, with interest. The benefit to the lender – their return – is capped at the interest rate. Lenders are therefore less concerned about growth and the value of the company. They care more about protecting their loan and minimising any risks that might jeopardise your ability to repay the loan. 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).

1. Philanthropy

Many social businesses 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. Once your organisation's capital needs exceed a basic minimum, you will wish to diversify into commercial sources of funding – i.e. debt and equity.

2. Equity

Equity is the most common way for early stage ventures to raise external finance. Raising equity involves selling a percentage of your company to outside investors via shares. The key negotiation with investors will therefore be around the valuation of your venture (i.e. how much your company is worth).

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.

Share capital (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 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 (at least 5-10x their original investment within 7 years). This is true even for socially motivated investors, given the high risk they are taking (most equity investments in early stage companies fail within 5 years and the investment will be completely written off).

One example for this investment type is the [Triodos Sustainable Equity Fund](#). It offers investors into the fund a high risk investment, while buying shares of companies fitting the social and environmental criteria set out by Triodos. The investment horizon is long term, e.g. 5 to 10 years. The return to the investors was 10,4% in 2015, from social enterprises across different sectors and geographies.

There are two kinds of shares:

- **Preferred shares** rank ahead of ordinary shares in the event of any pay-out (such as if the company was liquidated or sold) and are the normal form for outside investment to be made. They may also have special voting rights. We provide a term sheet for a Preferred Share later in the toolkit.
- **Ordinary shares** are the shares awarded to founders and staff. Ordinary shares get paid last, after preferred shares and all creditors of the company.

In addition to valuation, equity investors will be very focused on their exit from the investment (i.e. how they will get their money back, with a financial return). Typically this will involve selling their shares for a higher value to someone else at some point in future.

Please note that it is beyond the scope of this toolkit to be able to help you work out a valuation for your Company. In the Appendix we provide some details on how the methodology works for doing a company valuation. However given the technical complexity, you will need the services of a corporate finance advisor to assist you with preparing the valuation.

3. Debt

Debt for social ventures is typically in the form of a **loan** from a bank, fund, or direct from wealthy individuals. 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 more risky for the enterprise than equity is. 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 insolvency (bankruptcy). Since debt is more risky 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.

The exception to this are start-up **convertible loans** made to a business in its early stages (seed round and prior). 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 is a loan, which can be converted into equity 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 premium to the new shares (usually around 20% - i.e. \$100 of loan will become \$120 of shares) in order to reward the loan investors for having taken earlier risk on the company. The convertible loan usually has a flexible repayment schedule as well, so that if the company does not have enough profits in early years to be able to repay, then loan payments can be rolled over without defaulting. We provide a sample Term Sheet for a Convertible Loan later in the toolkit.

Working capital facilities

There is one special form of debt that we wish to highlight known as a **Working Capital Facility** (also known as a 'revolving line of credit'). 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.

Most 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.

The due diligence process

Investors of all types – grants, debt, equity – will go through a process called due diligence before making any investment. This toolkit is designed to help you through that process – both to make sure that you have the fundamentals right in your venture so that you are set up for the greatest chances of success, and also so that you can communicate to an investor all the things that they will be looking for in their due diligence process.

In the due diligence process, an investor is trying to understand:

- the potential levels of return they can expect to see from their investment, from both a social and a financial perspective;
- how their investment will be used and that it will not be wasted;
- what the risks of investing in the enterprise are or could be – ie what could go wrong and how likely that could be to happen;
- what the potential routes out of their investment in the future will be once the enterprise can be financially self-sustaining or profitable. This is known as the “exit” and it will enable investors to pursue other projects.

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