Title: Hybrid Financing Instruments for Social Purpose Organisations

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Thesis

Abstract

In the last decade, Social Purpose Organisations (SPOs) have been developing and adapting innovative business models to achieve their mission. However, these new and sometimes complex business models have financing needs that don't match conventional financing instruments. So, there has been a growing need to develop alternative financing instruments and mechanisms to meet these new business models' needs.

In the growing field of Impact Finance, innovative funders have been experimenting with novel financing instruments that combine elements of grant, debt and equity in a way that responds to the financing needs of the Social Purpose Organisations and is closer to achieving the best possible alignment of risk, return and impact for the investors. These combinations are called hybrid financing instruments. However, there is a lack of systematic learning from the use of these instruments and there's still a confusing nomenclature. At the same time, there isn't a clear application context for these hybrid instruments in terms of the scenarios and the conditions that call for their use as effective financing mechanisms that generate virtuous incentives for the different parties of a financing transaction.

In this thesis we intend to analyse specific hybrid financing instruments used in practice and identify the ideal conditions for the application of each one, regarding Social Purpose Organisations' specific business models and life-cycle stages. Thus, we intend to develop a mapping of hybrid financing instruments focused on a single investor and a single financing contract, that will allow the commitment of traditional lenders, corporate partners, foundations and other stakeholders to the development of solid, professional and financially sustainable organisations. For each hybrid financing instrument analysed we will draw learnings from specific applications and discuss its most relevant uses.

Table of Contents

1 – Introduction **4**
1.1 – Social Purpose Organisations 4
1.2 – Impact Finance 6
1.3 – Conventional Financing Instruments used in Impact Finance 8
1.3.1 – Grants *8*
1.3.2 – Loans *9*
1.3.3 – Equity *10*
1.3.4 – Hybrid Finance and other emerging instruments *11*
2 – Hybrid Financing Instruments **12**
2.1 – Recoverable Grant 13
2.2 – Convertible Grant 16
2.3 – Forgivable Loan 18
2.4 – Convertible Loan 20
2.5 – Revenue-based Loan Agreement 22
2.6 – Revenue Royalty Certificate 24
2.7 – The six hybrid financing instruments at a glance 25
3 – Hybrid financing instruments and SPOs business models **26**
3.1 – Market business model 27
3.2 – Blending business model 27
3.3 – Bridging business model 29
3.4 – Coupling business model 29
4 – Hybrid financing instruments and SPOs life-cycle stages **31**
4.1 – The Societal Problem 32
4.2 – The Business and Impact Models 32
4.3 – The Scaling-Up Process 33
4.4 – Mainstreaming of the Social Innovation 34
5 – Conclusions **36**
6 – References **37**

1 – Introduction

We will start this chapter by describing the origin and the evolution of the terms Social Purpose Organisation (SPO) and Impact Finance. Then we will shortly analyse the main conventional financing instruments used – grants, loans and equity – and their applicability in Impact Finance. Finally, we will refer the recent developments to support the growing need of financing alternatives for SPOs. This will lead us to the following chapter's detailed discussion: the hybrid financing instruments.

1.1 – Social Purpose Organisations

Social Purpose Organisation (SPO) is an umbrella term that includes social sector organisations and social enterprises. According to the 2014 G8 Social Impact Investment Taskforce report, the former includes charities, not-for-profit solidarity enterprises and other profit- or dividend-constrained organisations. The latter use commercial means to achieve a social or an environmental mission. The definitions may vary in different legal environments but Grassl (2012) explains that, in general, social enterprises are different from traditional not-for-profit organisations because they seek revenues and even profits to invest in further growth, hence aiming to achieve greater impact. In some legal environments, Social Enterprises can have a for-profit status and can even distribute dividends. In others, there are limitations that can be a constricting factor in the available financing models and instruments. The terminological proliferation that exists in the Social Area is not only due to the different legal environments and its several limitations. It also happens because the field is quite new and has been developing in a non-structured and non-organised way according to its own needs and players (Grassl, 2012).

Despite the development in impact investing in the last decade, conventional Finance has yet to interiorise that enterprises can simultaneously generate financial revenues and even profits and create a positive social or environmental impact. So the word hybrid[1] is still very commonly used to describe the operating model of all types of social enterprises (Battilana et al., 2012). It indicates that they might have two distinct operating models, one to generate profits and another to generate impact. Depending on the enterprise's business model the two operating models may be completely aligned or just overlap in a particular extent. We discuss business models ahead.

A recent study from The Zeppelin University and The Siemens Stiftung (Hanley et al., 2015) reveals that an increasing proportion of SPOs are for-profits and hybrids. This shift from a traditional not-for-profit profile is a consequence of the stronger need to create sustainable financial business models after the 2007/2008 financial crisis and the SPOs' desire to be less dependent on grants and donations (Battilana et al., 2012). Furthermore, impact investors mainly fund for-profit enterprises: according to the same study, 62% of impact investors' portfolios are for-profit, 30% are hybrids and only 6% are not-for-profit.

Starting out as a not-for-profit can be a way to safely move towards the early stages of an SPO. But because of the restraining financial options, some not-for-profit SPOs try to migrate their model towards a for-profit one. EMBRACE[2] is a successful example. It is a low-cost infant warmer, launched first as a not-for-profit. Nevertheless, its founders were always focused on developing a sustainable business model to take the enterprise's vision to maturity. Later they created a for-profit to raise start-up capital (Halais, 2015). A different example is One Acre Fund[3]. It provides financing, training and inputs to small farmers in East Africa. Even though it is working toward financial sustainability, it has always been adamant in its choice of operating as a not-for-profit because it operates in a context of market failure (Halais, 2015).

[1] Hybrids are defined by Battilana et al. (2012) as SPOs that simultaneously generate impact and commercial revenue through a single, unified strategy.
[2] https://www.embraceinnovations.com
[3] https://oneacrefund.org

1.2 – Impact Finance

The term ”impact” includes social and environmental impact, meaning the production of enduring value for the society and the environment (Impact Finance Center, 2017).

Impact Finance is also known as Social Finance. We believe the former is a more inclusive term as it includes both social and environmental areas, and we will use it henceforth. Impact Finance spawns from pure philanthropic grant-making, with zero expectations of refund, to impact investment, that expects capital and a positive financial return (Nicholls, 2017). So Impact Finance can be defined as managing the full range of capital used to finance all organisations that are impact oriented, previously defined as SPOs, including a vast spectrum of risk and return models from the 100% loss capital allocation of philanthropy to a market or above market returns model (Nicholls et al., 2015). The following figure represents this graphically.

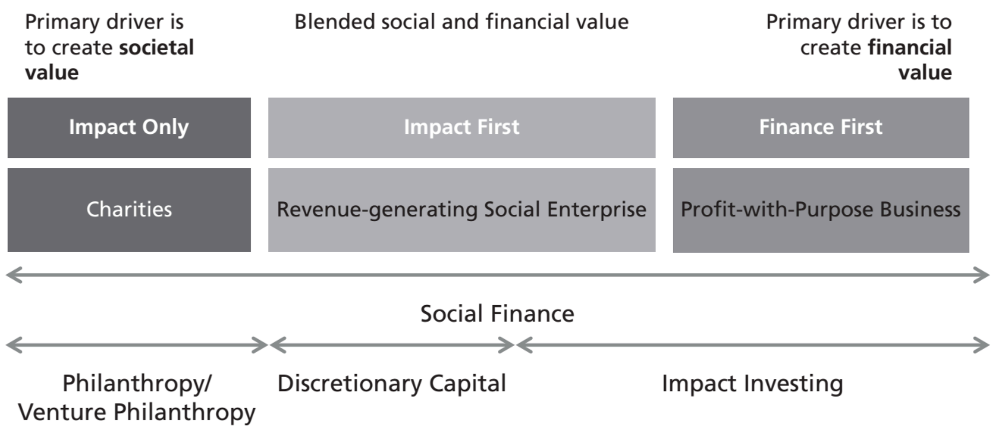

Figure 1 – Spectrum of Impact (Social) Finance (Nicholls et al., 2015)

In the last fifteen years a number of traditionally grant-making institutions have been migrating to what is called Venture Philanthropy. The name is derived from the concept of Venture Capital and according to Balbo et al. (2016), it is a high-engagement and long-term approach to supporting SPOs through tailored financing, organisational support, impact measurement and management. The Draper Richards Kaplan Foundation is a good example of an organisation dedicated to one end of the spectrum, the grant-making field, incorporating already the Venture Philanthropy concept. Yearly it selects early stage SPOs that have a potential for growth and provide them with $300,000 of unrestricted capital over a 3-year period (Draper Richards Kaplan Foundation, 2017). Two of their most famous alumni are Kiva[4] and VisionSpring[5]. In 2004 the European Venture Philanthropy Association (EVPA) was launched to promote Venture Philanthropy and Social Investment in Europe. Today it incorporates more than 200 members from over 25 countries that share best practices and a common vision (EVPA, 2018).

In parallel and a decade ago, it became clear that government/ public funding and philanthropic grants were falling short of the capital needed to tackle the growing global environmental and social challenges the world was facing (The Aspen Institute, 2014). A train of thought started to emerge: one that believed that combining the aims of financial and impact returns could, in certain scenarios, outperform the pure market and the pure philanthropy operations (Trelstad, 2016). This was an invitation for traditional financial investors to invest in SPOs and may be seen as the birth of what is called Impact Investing. In 2009, the Global Impact Investing Network (GIIN), defined impact investment as "*investments made into companies, organisations and funds with the intention to generate measurable social and environmental impact alongside a financial return*". This broad definition concluded with specifically referring that this kind of investments could be done in any type of market and target a broad range of returns.

According to The Aspen Institute (2014), an increasing number of foundations are becoming active impact investors, side by side with their traditional role as grant-makers. Private sector players such as Goldman Sachs and Morgan Stanley are developing business units dedicated to impact investing. And Bank of America sees its HNWI[6] seeking ways to integrate their social and environmental values in their investment strategies. With all these new players there has been a positive leap of capital influx into the Impact Finance market.

[4] http://www.kiva.org
[5] http://visionspring.org
[6] High-net-worth individuals.

In its most recent survey, GIIN reported that in 2016 there were $114bn in impact investment assets managed by 208 impact investing organisations (GIIN, 2017). In 2016 this sample invested $22bn in almost 8,000 new deals and planned to increase the capital invested by 17% and the number of deals by 20% in 2017. Almost two thirds targeted risk-adjusted market return rates. The others divided themselves between returns closer to capital preservation and below-market-rate returns closer to market-rate. The last EVPA bi-annual report (Boiardi et al., 2016) surveyed 108 respondents from 21 countries, and reported a VP market of over €6.5bn invested since inception. Data from the UK, one of the pioneering European countries in the area, accounts for social investments outstanding at the end of 2015 worth £1.5 billion, representing a 20% annual growth since 2011 (Robinson, 2016).

All the evolution seen in the financing area in recent years and the aim of social entrepreneurs to go a step forward with their innovations and their impacts have created a path to the development of innovative financing experiments and solutions. Although still in its early years, Impact Finance has the potential to grow steeply and provide the funding needed to tackle the world' social inequalities and environmental issues.

1.3 – Conventional Financing Instruments used in Impact Finance

1.3.1 – Grants

Until recent years the major capital inflows for SPOs have been grants from foundations, individuals and charitable organisations, alongside with government contracts (Nicholls et al., 2015). Grants and donations are one of the safest ways to finance an SPO through its risky first stages as they are non-repayable. Social entrepreneurs tend to favour unrestricted grants, like those from the Mulago Foundation[7], that help support organisational growth as a whole. Nevertheless, the majority of grants are given for short-term specific programmes and most of them tend to be inflexible and narrowly programmatic. Although free money has an undeniable appeal, SPOs are increasingly looking for

[7] http://mulagofoundation.org

capital with less restrictions, to better support their will to increase their operational performance and to support their scaling activities.

1.3.2 – Loans

According to Nicholls et al. (2015), there are five basic debt options for SPOs: mortgage finance, credit cards, bank overdrafts, commercial loans from banks at market rates and commercial and semi-commercial loans from social investors. The latter are characterised by below-market interest rates, longer repayment contracts and have the possibility of "holiday" periods[8]. Venugopal et al. (2012) also refers to concessional or flexible loans: those that include special features as zero or below-market interest rates, longer repayment terms and interest rate modifications during the life of the loan. For instance, loans with longer repayment schedules are very appropriate for low-carbon projects like on-grid solar installations. These kind of projects have high upfront costs, and it may take years before the enterprises can recover the initial investment and pay the loan principal back (Venugopal et al., 2012).

In general, loans allow any enterprise to access critical funds to cover upfront costs (through short- and medium-term loans), temporary costs (through bridge financing or credit lines) or ongoing costs (through long-term loans) (Venugopal et al., 2012). Conventional loans usually require collaterals. From a funder's perspective, a debt contract will provide a fixed repayment plan and a defined investment return (Gianoncelli et al., 2017).

Loans allow greater freedom for the SPO to use the money. Nevertheless, not-for-profits may find it hard or even impossible to access loans as there is a need for cash-flow to pay interests and make repayments. Also they might not have enough assets to provide as collaterals to guarantee the loan.

Debt contracts aren't usually adequate for early-stage SPOs, as there isn't yet proof of scale and probably no assets to present as collateral. Conventional debt contracts aren't also adequate for SPOs with big variations in cash-flows, as these contracts usually don't have flexible payments and place the

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[8] "Holiday" or grace periods exist when there is an agreement for suspending interest payments and sometimes capital repayments for specific periods of time.

financial risk solely on the SPO. Only for more mature SPOs with tangible assets and sustainable flows would debt financing seem a viable option.

1.3.3 – Equity

Another instrument from conventional Finance used in Impact Finance is equity investment. It basically works in a similar way: there's an influx of capital in exchange for some ownership and control over the enterprise. The main differences are usually in the SPO's governance arrangements (Nicholls et al., 2015) where, for instance, there might be some restrictions to the freedom of the board to ensure mission-lock or there might be a clause to guarantee that a specific part of the SPO's profits are reinvested in the scaling up of the organisation and not distributed as dividends.

Equity is an adequate option for Impact Finance when the SPO has a strong potential growth and there is an exit option. The SPO also has to have a for-profit legal form to allow the payment of dividends and the selling of equity (Gianoncelli et al., 2017).

From an investor's perspective, loan contracts are less risky than equity investments because they are paid back before the latter if an enterprise falls into financial trouble (Venugopal et al., 2012). From the SPO's perspective, debt provides low-cost finance without relinquishing ownership.

On one hand, it is very difficult for an enterprise to grow without adequate equity, as lenders may avoid lending capital to an enterprise that doesn't have a basic level of internal funding (Venugopal et al., 2012). On the other hand, the inexistence of any fully functioning "social" stock market in the world, with the resulting lack of liquidity and exit options, is a restraining factor for the growth of this financing instrument in Impact Finance (Nicholls et al., 2015). When a funder makes an equity-investment in an SPO he[9] is looking for a long-term investment, typically for a period of six to eight years (Boiardi et al., 2016).

[9] To facilitate reading, only the masculine form is used in this document; all references to the male gender shall be deemed and construed to include the female gender.

Recent years have shown that grants, loans and equity are falling strongly short of SPOs needs and fragilities. Grants are usually short-termed and usage-constrained, restraining scaling and working capital investment. Loan contracts require cash-flow stability and assets as collaterals, both difficult for most SPOs to achieve. Equity, although an efficient investing tool, requires that the investor and the investee agree on a valuation, which may be quite difficult in the early stages of development. Equity also requires that the investee relinquishes part of the SPO's ownership and control, jeopardising the impact mission. Due to the difficulties with traditional instruments, new financing instruments and mechanisms are being developed to support the creation and growth of impact-oriented enterprises.

1.3.4 – Hybrid Finance and other emerging instruments

Gianoncelli et al. (2017) defines Hybrid Finance as the allocation of capital to SPOs combining different types of financing instruments and different types of investors' profiles. It has been growing its importance in Impact Finance because its main objective is to unlock capital by improving the risk/ return profile of investment opportunities. There are two main financing structures in Hybrid Finance: vehicles and mechanisms (Gianoncelli et al., 2017). Vehicles are Funds with a portfolio of SPO investments that satisfies a pool of investors with different risk/ return/ impact profiles and reduces their transaction costs. Mechanisms are developed in a deal-by-deal approach and aim to increase the capital inflow into Impact Finance by de-risking traditional capital. Some examples of mechanisms are guarantees[10], subordinated debt[11] and outcome-based schemes like Social Impact Bonds[12].

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[10] To help SPOs in accessing loans, some VP organisations have been leveraging loans with guarantees. In this kind of contracts there are two intervenors: the grantor and the lender. Guarantees can improve liquidity, unlock additional capital (GIIN, 2017) and even reduce the interest rates (The Aspen Institute, 2014).

[11] A VP organisation can de-risk a loan by lending part of the capital as a subordinated debt (Venugopal et al., 2012). This way if the SPO falls back on its loan payments, the senior debtors will be payed first.

[12] Social Impact Bonds (SIB) or Pay For Success (PFS) is an innovative type of public/private partnership that uses private capital to invest in social programmes. Not-for-profits deliver the programme and the government pays for the outcomes (which produce net long-term public savings) only if the programmes succeed (The Aspen Institute, 2014). This mechanism shifts the risk from falling entirely on the public administration that procures the service to being shared by the public entity, the social service providers and the investors (Arena, 2017).

Several other instruments that are distinct from the mainstream have emerged in recent years. They have been created by the need to attract capital and have had several degrees of success. All of them are enriching this experimental field but there isn't a receipt for a guaranteed success in each one's application. Some examples from Nicholls et al. (2015) are crowdfunding strategies, revenue redemption structures[13] and co-operative and mutual investments[14]. To all these we add those that we believe also have potential to increase the financing options of Impact Finance: hybrid financing instruments, that combine characteristics of traditional grants, debt and equity in different ways.

2 – Hybrid Financing Instruments

In the growing field of Impact Finance, innovative funders such as some foundations, impact investment funds and intermediary organisations have been experimenting with novel financing instruments that combine elements of grants, debt and equity in a way that responds to the financing needs of SPOs and is closer to achieving the best possible alignment of risk, return and impact for the investors (Gianoncelli et al., 2017). These combinations are called hybrid financing instruments (Bugg-Levine et al., 2012; Oldenburg et al., 2016). These instruments are also called hybrid capital (Cusumano et al., 2012) and include recoverable grants, convertible grants, forgivable loans, convertible loans, revenue-based loan agreements and revenue royalty certificates. Some of them have shifted from those usually referred to as mezzanine financing, which combines elements of debt capital and equity capital, towards a financing logic more related with donations and impact (Arena, 2017). They are all very flexible and can be structured and re-arranged according to an organisation's results.

The following figure shows the six instruments distributed in a way that allows us to understand the dual hybridity of each one: recoverable grants and forgivable loans with characteristics of grants and

[13] In these kind of structures there's an agreement between the enterprise and the equity investors that the former will buy back shares out of a percentage of future revenues (Nicholls et al., 2015).
[14] Where enterprises are totally or partially owned by the employees, the customers or the local community (Nicholls et al., 2015).

loans, convertible grants and royalty certificates with characteristics of grants and equity, revenue-based loan agreements and convertible loans with characteristics of loans and equity.

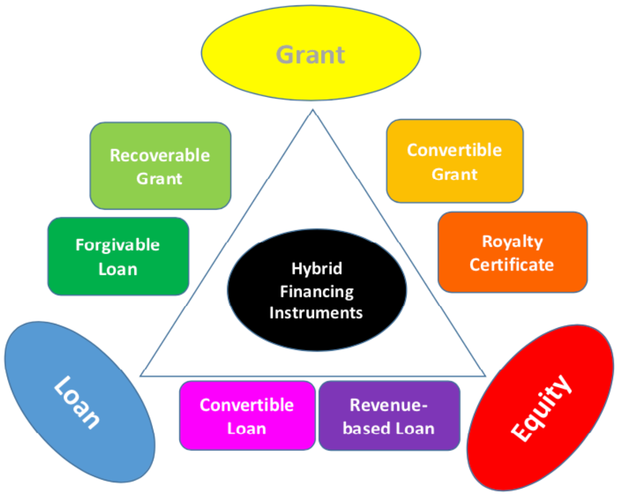
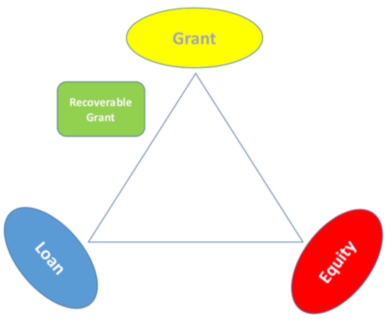


Figure 2 – Hybrid Financing Instruments (adapted from Santos, 2017)

In the next six sections we will discuss in detail each one of these hybrid financing instruments. We will find out that some of them have had several experiments and others not as many as they would deserve. For the latter we will describe in what circumstances we believe they should be applied and why. The seventh section will systematize the discussion.

2.1 – Recoverable Grant



There isn't an established definition for the term "recoverable grant". Thus, grant givers and impact investors are defining it as they implement deals.

For Open Road Alliance (2017) recoverable grants are "*charitable funds … that function like a loan and are repaid … after a set period of time*". Despite Open Road Alliance's definition, some examples described in their website, like TakaTaka Solutions and Homeboy Recycling, are loans used to cover unexpected financial necessities due to political and social instability.

From an accounting point of view, they are flexible loans with below-market return rates and with investee-led repayment conditions. Additionally, Open Road Alliance's recoverable grants may be converted into conventional grants if the recipient is unable to repay under extraordinary circumstances.

For Pease (2015), a recoverable grant is a "*cash stipend … awarded to a for-profit organisation. … The organisation agrees to pay back the stipend if it becomes financially successful*". This definition is closer to what we consider a recoverable grant.

A third definition can be found in an Aspen Institute's report (The Aspen Institute, 2014) where a recoverable grant is "*a grant to an organisation with a commitment from the investee to repay under specified circumstances*". To support its definition, the Aspen Institute's report describes the following conceptual examples:

- A foundation makes a recoverable grant to a housing agency to help finance the cost of a site plan application to a zoning and planning commission. If the project is approved and the financing is secured, the housing agency repays the grant.
- A foundation makes a recoverable grant to a new social enterprise with an agreement that if it reaches a pre-defined profitability milestone it will repay the grant.

The common factors between these two examples are that the grants are given unconditionally and they will only be paid back if certain milestones are achieved, being it the guarantee of an approved line of credit or the accomplishment of a profitability index.

As far as this thesis is concerned, a recoverable grant is essentially a grant that is converted into a loan with a typically below-market return rate if a predefined milestone, usually a positive one, is achieved. The milestone should be mainly financial or have positive financial implications, as it triggers the need to repay the funds received.

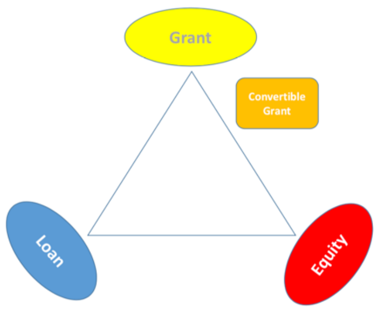
According to Varga et al. (2016), recoverable grants were designed to focus the investee on sustainability and reduce the risk of grant dependency. From the examples found we believe that this instrument was also developed by investors focused on creating good outcomes with pilot money for potentially financially sustainable projects but with the aim of getting their money back and recycle it in further projects. Recoverable grants are preferably used for early-stage SPOs, where there's a need for risk tolerant and inexpensive capital. They can be used for hybrid SPOs[15] and for for-profit SPOs[16] but they aren't adequate for not-for-profit SPOs[17], as these won't usually generate enough revenues to repay. There are also references of its applicability in the transition process of a not-for-profit organisation to a for-profit or hybrid one (Echoing Green, 2017). This intention is aligned with the main objective of the instrument: if there's a goal of being financially sustainable with a capital investment, then the capital can create even more impact being recycled to the funder and reinvested in other SPOs. Recoverable grants are wildly used by Echoing Green[18], a not-for-profit enterprise with a 30-year track record of finding, selecting and supporting successful impact entrepreneurs through its Fellowship Programs (The Aspen Institute, 2014). It started using recoverable grants in 2011 to finance for-profit and hybrid SPOs. It has been financially and non-financially supporting a global community of more than 700 impact entrepreneurs across all continents, and helping the development of SPOs like One Acre Fund, Teach For America and SKS Microfinance. Typically, it only accepts applications from independent organisations that are within the first two years of operation with fulltime staff, clearly early-stage organisations. According to its website on July 2017, during the 2-year Fellowship Programs it grants between $80,000 to $90,000 to each project selected and the payback for each recoverable grant is triggered when the SPO achieves either $2 million in annual revenues (with a positive net income) or when it is valued more than $5 million. After 10 years without achieving either of the triggers, the recoverable grant is converted into a conventional grant. Echoing Green is clearly financing high-risk projects, as one of its pre-conditions is the candidate being an early-stage organisation. According to its moto, it "*… spots emerging leaders and invests deeply in their success to accelerate their impact*".

Impact investors have a lower financial cost with recoverable grants than with conventional ones, as the former allows them to recycle their investment capital from successful investees into future ones, thus increasing their global impact. The financial risk associated with this hybrid financing instrument

[15] Their business models include two traditionally independent models: a social/environment welfare model and a revenue generational one. They may overlap in a wide range of degrees.
[16] They can legally generate profits and have a business model to achieve it.
[17] They can't generate profits, either because they can't legally do it or because their business model won't generate enough revenues to cover the costs, or even not generating any revenues at all (a pure charity organisation).
[18] http://www.echoinggreen.org

is on the investor side. For the investees, recoverable grants have lower financial risk than loans, as they only payback if and when the pre-defined threshold is achieved. For the success of this kind of agreement, both sides must be aligned with the negotiated threshold, usually a measurable annual revenue amount, but also with the impact to be achieved. There's always a risk of mission-drift when the milestone is a financial indicator. It will be significant or not, depending on the focus of the SPO's management. Independently of each deal's output, impact investors will not have equity-shares in the SPOs in which they invest. Their aim is to boost early-stage for-profit and hybrid SPOs and recycle their investment to finance others. If impact investors want to be part of the future stages of SPOs, then they should use convertible grants and not recoverable ones.

2.2 – Convertible Grant



A convertible grant is a hybrid financing instrument that is initially a grant and that is converted into an equity stake when a funding milestone is achieved (Massachusetts Clear Energy Center, 2017). Depending on the agreement, the conversion can be automatic or optional. In most agreements both options are possible.

When there's a round of equity financing with other investors, the convertible grant may automatically be converted into the same class and series of equity securities issued in that round. In some cases, there's a predefinition of a scale of discounts based on the timeframe in which the qualifying financing round occurs. This is a protection for the investor as the investment will not be diluted with the entrance of other equity financing investors. The optional conversion may occur if some strategic events happen like a change of control, the sale of a significant number of assets or any other event that might alter or harm the organisation's business. For either conversion to happen, the enterprise must have a valuation. The convertible grant remains a grant until the term finishes.

Like for recoverable grants, the financial risk associated with this hybrid financing instrument is on the investor' side as the investee doesn't have to pay back the capital or waive equity if the project doesn't reach its objectives. To minimise the investor's risk and maintain the enterprise's focus on the financial goal, only the investor can execute the optional conversion feature. Also to mitigate the investor's risk some agreements have penalty financial clauses like the obligation to pay back the grant with interests.

The impact investor that uses convertible grants instead of recoverable grants demonstrates his interest in having an equity-participation in the future of the SPO, as long as it reaches financial sustainability and moves beyond. Nevertheless, his stakes are high as he might lose all his investment if that doesn't happen.

This hybrid financing instrument is mostly used in seed-stage. We found some cases where it is used to assess a project's feasibility and others in a proof-of-scale.

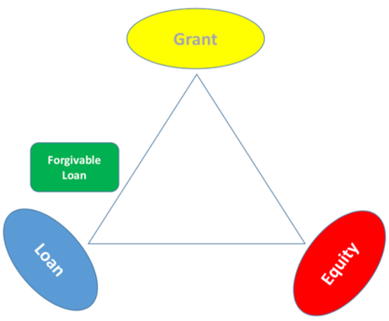
The following example is a successful use of a convertible grant used for assessing a project feasibility. Clean Energy is a special purpose vehicle (SPV) set up to construct and operate the Salkhit Wind Farm in Mongolia[19], the first of its kind in the country. The wind farm[20] started operating in 2013 and earns revenues by selling the energy it produces to the country's electricity providers. It also earns additional revenues through selling carbon credits. The prime investor was FMO[21], the Dutch development bank. FMO was interested in this investment opportunity primarily because of its environmental impact potential. The first round of investment was a 672,000 € one-time convertible grant to assist in the business planning and assess the project's feasibility. After the success of this phase, the grant was converted into equity. Presently FMO has a more complex financial investment in Clear Energy: 21.4 million € in senior debt and 5.3 million € in equity (including the convertible grant). The equity stake represents 15% of Clear Energy shares and FMO has the option of exiting the structure within a defined time period (GIIN, 2017; FMO, 2017).

The Massachusetts Clean Energy Center (MCEC) grants are another very good example of a complex convertible grant agreement, with penalties and even the obligation of returning all the capital under specific conditions. MCEC uses convertible grants to finance investees whose technology or service qualifies as contributing to the advancement of one or more of the renewable energy or energy

[19] http://www.cleanenergy.mn/en/
[20] Wind farms are groups of wind turbines that use renewable wind power to generate electricity without producing greenhouse gas emissions.
[21] FMO specialises in sectors where its contribution can have the highest long-term impact, namely financial services, energy, agribusiness, food and water.

efficiency technologies as defined by the Green Jobs Act. The money granted has to be used specifically in working capital requirements and business activities during seed-stage and while defining the business model and assessing the project's feasibility. When an investee has a more than $1 million-equity-financing round, the grant converts automatically into equity with the same conditions of the financing round, e.g. the number of shares will be based on the same share price and will also take into account a time-based discount. If the investee isn't able to find this type of financing until the term expires, MCEC has the option to convert the grant into equity at the current fair market value. MCEC also has the conversion option in the event of a change of control, a sale, a lease or a license of all or substantially all of the investee assets or in case of default. The financial risk is on MCEC's side because it has no security in the investee's assets. There are some rules that the investees have to agree on, or they might have to pay the grant back. For instance, MCEC only gives these grants to enterprises that have a "*significant Massachusetts presence*" so if an enterprise decides to move part of its operation outside the Massachusetts state, the grant has to be paid back. To prevent mission-drift, if the investee no longer qualifies as a clean-tech company and if the convertible grant is outstanding, the investee has to pay back the full amount of the grant plus 15% in premium.

2.3 – Forgivable Loan



According to the 2002 United Nations Conference on Trade and Development, forgivable loans are loans that the lender undertakes with clauses to waive repayment under certain prescribed conditions. Impact Finance has adapted this concept to focus on loans that the lender undertakes with the option to waive a part or all of the principal's repayment if certain pre-defined impact achievements or KPIs are reached.

Forgivable loans are not usually provided by banks. Instead, some governments and foundations provide such loans to encourage investments in risky business areas, like building a solar panel manufacturing factory. The general aim is to lower the risk of investing in high potential and simultaneously high growth areas. For the investee this financing instrument works as an incentive to fulfil the impact demands of the investor because if he succeeds, part or all of his financial liabilities will be forgiven. If he fails, this financing instrument will be like a common loan, where the investee has to repay all the principal according to the contract conditions. Usually the interests are paid periodically during the life time of the contract, independently of the successfully fulfilment of the impact conditions at maturity.

When using a forgivable loan in Impact Finance one has to understand that the waiving conditions are only dependent on the project's impact achievement. The financial sustainability of the project is not taken into consideration. So a project may not achieve the predefined impact conditions but be financially viable. This separation leads to four possible outcome scenarios. (A) The project achieves the investor's impact conditions and is financially viable. This is a win-win situation: the investor will waive part or all of the principal repayment because his impact conditions were achieved. The investee receives a financial pardon and can go on developing his impact and financially sustainable business with total ownership. (B) The project achieves the impact conditions but isn't financially viable. In this case the investor will also have his impact return. With the principal's repayment pardoned the investee will have a second chance to rethink his business model to make it financially viable or to apply for a grant to continue its development as is. (C) The project doesn't achieve the impact conditions and is financially viable. The investor gets his money back but not his aspired impact return. The investee has to pay back all the principal as an ordinary loan and has a financially viable business to run. He will have to decide if he maintains it as is, or revises the business model to achieve more impact. Eventually the investor conditions were too ambitious and the investee agreed with them to get the loan. (D) The worst case scenario will be a project that is simultaneously financially unviable and doesn't achieve the investor's impact conditions.

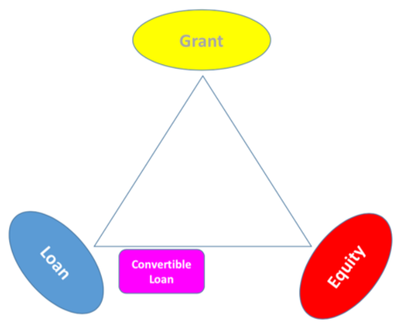
In scenarios A, B and C the investor has one or both of his aspired returns: financial and/or impact return. Scenario D is quite undesirable, as the investor may not get total refund of his investment together with the unsuccessful attempt to create impact.

This hybrid financing instrument is very appropriate for SPOs that have their financial plan clearly defined but don't have their impact model well organised. They might not even completely understand what is the social or environmental reach of their business. A Foundation or a Social Bank may give them a forgivable loan to encourage focus on specific impact results, thus giving them financial capacity to change what is needed in their business model to enhance their impact. So this is not a financing instrument for early-stage where scenario D has a high probability of happening. It is more adequate for stages with less financing risk and where there's already a sustainable business model. Being "forgivable" this instrument is an incentive to achieve the milestone.

We didn't find concrete applied examples so this is an instrument that may be underused given its potential. We identified a few areas where we believe this hybrid financing instrument could be appropriately used.

- The enterprise that wants or has the potential to become a B Corp[22].
- The SPO that has a well-defined and sustainable business model but that has an ill-defined impact model or none at all.
- The enterprise that operates in the mainstream market but an impact investor believes it can use the same business model with an impact. For instance, a programming academy. The recoverable loan can be given with the milestone of achieving a pre-defined number of people from a disadvantaged social group (e.g. long-unemployed 40-year-old people) to finish the training and even getting a job. If the milestone is achieved, the enterprise has created a new business area and might see the total loan forgivable.

2.4 – Convertible Loan



In conventional Finance, this hybrid financing instrument entitles the lender to convert the loan into ordinary or preferred shares at a pre-defined conversion rate and within a specified timeframe. The main advantage for the investee is the maintenance of the enterprise control until the conversion moment. Another advantage is that usually this type of loan doesn't require an immediate interest payment, as the interests are usually accrued

[22] B Corps are for-profit companies certified by the not-for-profit B Lab to meet rigorous standards of social and environmental performance, accountability and transparency." (B Lab, 2017).

and converted to equity later. The main disadvantage for the investee is that the investor, being a lender, has the priority right at maturity to claim any assets if default is reached and if he decides not to convert the loan. So if there are assets to be claimed (like cash, software, hardware and machinery) most of the financial risk will be on the investee side.

According to Bugg-Levine et al. (2012) this hybrid financing instrument, also called convertible debt, has the same behaviour in conventional Finance and in Impact Finance. The payment structure is fixed with conversion, the investor has a preferred claim on assets and the instrument has a medium financial risk and return. Like convertible grants, convertible loans may have automatic and optional conversion triggers. According to Varga et al. (2016), there are two main events that can trigger a conversion: a successful funding round and the lender's will to change the loan terms in the SPO's favour. The first event will trigger an automatic conversion, like it was described for convertible grants. The second one may lead the investee to give the investor the rights to exchange its creditor position for an equity-stake in the SPO at a later date, even before the funding round, and with a tangible valuation.

A convertible loan is used in two main scenarios. It can be an intermediary source of financing, like a bridge financing, while a larger financing round is being negotiated. It can also be used when the investor and the investee don't agree on the valuation of the enterprise or an equity price, a common situation with an SPO. In this case, the valuation will be defined during a follow-on financing round when there will be more data on which to base a valuation, avoiding the risk of a "down round"[23].

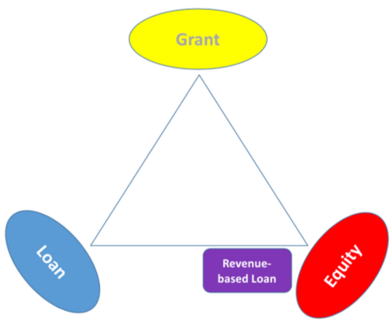
Although the most common trigger for the automatic conversion is the closing of a funding round, there are other events that can be used as trigger such as a revenue threshold. If the trigger has not been achieved at the end of the agreement timeline, there are two possible scenarios: the convertible loan converts into a conventional loan and the interests and the capital are repaid or both parts agree on adding a clause allowing the conversion at the discretion of the investor, the SPO or both.

In spite of being a typical instrument used in conventional Finance and a very applicable one for Impact Finance, we didn't find detailed cases about deals in Impact Finance using convertible loans. We can

[23] A "down round" is an investment round with a share price lower than the previous round.

only reference two enterprises that were involved in this kind of financing agreements: Krakakoa[24] and doctHERs[25]. The small number of cases found is probably a consequence of this instrument being most adequate for for-profit SPOs with a high potential for growth and exit prospects. This definition only applies to a small segment of SPOs, very alike traditional start-ups that traditional business angels and venture capital investors invest in.

2.5 – Revenue-based Loan Agreement



A revenue-based loan agreement, also known as a revenue-based finance (RBF) investment provides capital to an enterprise in exchange for a percentage of its future revenues over a specified amount of time or until a cap is reached (Wilson, 2011). It is a hybrid of a classic loan and equity investment. This financing instrument is most adequate for enterprises that are already generating revenues but without assets that are typically asked for as collaterals for bank loans. The major advantage over a conventional loan is the flexible monthly repayments adjusted to the business monthly revenues. This way, the enterprises make bigger repayments in months when they are thriving and lower repayments in slower months. It is quite attractive for seasonal businesses and for early-stage enterprises with their typical erratic cash-flows. The loan agreement predetermines the total repayment amount and the revenue share percentage. The flexibility of this tool is also in the maturity: the total payback period isn't fixed, varying with the business performance (Bolstr, 2017).

This financing instrument usually doesn't require the investor's participation in the enterprise's board and the financing doesn't depend on an agreed valuation of the enterprise or on personal guarantees from the managing team. For investors, this financing tool allows for a financial return aligned with the

[24] Krakakoa (https://krakakoa.com) is one of the first bean to bar chocolate Indonesian manufacturers. It was founded to improve the livelihoods of local cocoa farmers providing specific training to improve their yields. It raised capital from LGT Venture Philanthropy and Angel Investment Network Indonesia.

[25] doctHERs (http://www.docthers.com) is a Pakistani healthcare platform that connects female doctors with underserved patients, tackling two market failures: professional inclusion of women and access to quality healthcare.

success of the enterprise without needing an exit, which is one of the main contingencies in Impact Finance.

The quicker the total payback is made, the higher the investor's annual return rate will be. So the investor has an incentive to play an active role in the performance of his own investment. On the other hand, the longer the payback period, the higher cost of capital the investee will have, in rate of return terms, although repaying the same amount of initial capital. So the incentives for the investee and for the investor are totally aligned. As it involves the total capital reimbursement, it is best suited for growth projects like expansions, machinery renewal and new locations.

There are several possible variations in these deals. For instance, the interest rate may be fixed or flexible; the payback period may be fixed or flexible; the base for the payback calculation may be revenues, incremental revenues, EBITDA, cash flow or profit.

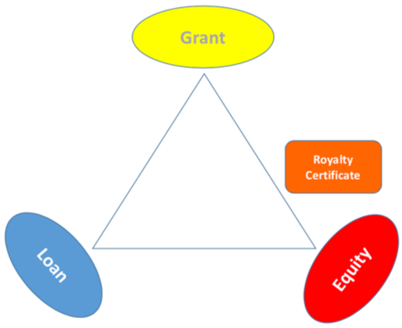
This financing instrument is a loan and doesn't convert to any other type of basic financing instrument. Nevertheless, it can be seen as a hybrid of a loan and an equity agreement, as the periodic payments are based on the enterprise's revenues or on other financial indicator.

The Financing Agency for Social Entrepreneurship[26] (FASE) is a German independent organisation that supports social enterprises in raising growth capital. They have been developing complex financing deals in the spectrum of revenue-based loan agreements. For instance, *vonUnruh & Team UG* is a German social enterprise created in 2014 that offers crisis and turnaround advice (FASE, 2014). It is a consultancy company managed as an SPO with an earned income strategy. It was created to fulfil the increasing demand of BV INSO, a German association created in 2010 that offers individual counselling and personal support to self-employed professionals and entrepreneurs who are caught in a business-threatening crisis. The financing model developed for them by FASE is a participation rights structure with qualified subordination and without loss participation. The remuneration is a percentage of the gross revenues with a cap on the yearly revenues defined as a percentage of the nominal amount and a catch-up to achieve the target return of up to a percentage of the nominal amount, to be paid as a lump sum at maturity. The financing agreement is for 10 years with the possibility of early repayment by the

[26] http://fa-se.de/en

company. The investor has information-rights, participation-rights and approval-rights but doesn't have shareholder-rights. The investment was made by the Ashoka Angels Network, a group recently created by Ashoka that comprises internationally successful entrepreneurs and managers. Besides financial investment, most of them also provide mentoring and non-financial support to their investees.

2.6 – Revenue Royalty Certificate



Impact Investing is struggling to find investments that provide sufficient returns. The area's main concern is the lack of exiting options, so impact investors need alternatives to equity, specially for early-stage investing.

An instrument recently developed to attract more financing to Impact Investing is the revenue royalty certificate (RRC). It is a new funding option for enterprises to raise capital where the investors will be entitled to royalty payments accrued on the enterprise's revenues. Like the revenue-based loan agreement, the investors won't have any participation in the enterprise's board. Likewise, there's no need for a pre-defined valuation or any personal guarantees from the managing team. The fundamental difference is that for the revenue royalty certificate the royalty payments, that include capital and interests, are only payable if and when certain income triggers are met (Varga et al., 2016). So the investor's risk is higher. On the other hand, a feature that makes this instrument more attractive for the investors is the option to sell the "bonds" to an external party, allowing them to exit without bringing disruption to the enterprise (Pennam Partners, 2018).

In this kind of financial investment, the total reimbursement of the capital invested is not guaranteed, as the SPO will only payback if it hits the performance targets previously defined. Hence, this financial instrument is considered a hybrid between equity and grant. Although the risk is on the investor side, it can be mitigated with the option of selling the "bonds". From the investee perspective, this kind of financing has the advantage of not having to waive control simultaneously with the advantage of not having the financial risk on his side.

We didn't find concrete data from applied cases, although we know that this instrument is often used in Project Finance[27]. Nevertheless, we can conclude that it can be used for not-for-profit and for-profit SPOs as long as they generate revenues.

2.7 – The six hybrid financing instruments at a glance

The following table systematises the main characteristics of the analyses done in the previous sections.

Instrument	***Hybrid characteristics***		***Investor's aim***	***SPO***	***Conversion***	***Trigger***	***Financial risk***
Recoverable grant	Grant	Loan	Impact + recycle capital	Early stage, for-profit	Automatic	Single event or financial indicator	Investor side
Convertible grant	Grant	Equity	Impact + future partner	Early stage, for-profit	Automatic or optional	Funding round	Investor side
Convertible loan	Loan	Equity	Impact + future partner	High growth potential	Automatic or optional	Funding round	Investee side
Forgivable loan	Loan	Grant	Impact	Sustainable business model	Automatic	Impact milestone	Investor side
Revenue-based loan agreement	Loan	Equity	Impact + revenue	With revenues	Not applicable	Not applicable	Both sides
Revenue royalty certificate	Grant	Equity	Impact + revenue	With revenues	Not applicable	Not applicable	Investor side

Figure 3 – Main characteristics of Hybrid Financing Instruments

Until here, the discussion has been from the viewpoint of the hybrid financing instruments. We now need to analyse from the SPOs' internal organisation and state of the art. There is a need to systematise

[27] Project Finance is the long-term financing of projects based on the projected cash-flows.

and answer questions like which hybrid financing instruments will be more adequate to a specific business model and/ or a life-cycle stage. So the next chapter will be dedicated to SPOs business models. We will choose one framework and detail it in order to identify the most adequate hybrid financing instruments for each business model. The following chapter will be dedicated to SPOs life-cycle stages. Again we will choose a framework to detail and identify the most adequate hybrid financing instruments for each stage.

3 – Hybrid financing instruments and SPOs business models

SPOs come in different models and sizes and the literature suggests several architectures for their business models. These models take in consideration one or more of the following criteria: ultimate ends, societal sector, type of integration, goods produced, product status, agents of value creation and ownership (Grassl, 2012). Alter (2006) and Grassl (2012) suggest that SPOs can be classified by their mission orientation, by the type of integration between their enterprise activities and their impact programmes and by the type of their target market. The combination of these three factors leads to the design of nine business models: Enterprise Support Model, Market Intermediary Model, Employment Model, Fee-for-Service Model, Low-Income Client as Market Model, Cooperative Model, Market Linkage Model, Service Subsidization Model and Organisational Support Model. Santos et al. (2015) suggests a framework for SPOs' business models based on a two-dimensional structure: the contingent value spill-overs and the overlap between the beneficiaries – the target population that the impact is supposed to improve life conditions for – and the clients – the population that will be served by the commercial products or services provided by the SPO. Using discrete variables, Santos et al. (2015) arrives at four resulting business models: Market Model, Blending Model, Bridging Model and Coupling Model. This framework describes four specific scenarios, with a grey area between them. We will analyse in detail this last framework as we are interested in understanding how will the distinction of clients and beneficiaries and the direct and indirect impact generation influence the financing options.

3.1 – Market business model

This business model is quite identical to a conventional for-profit enterprise business model; the difference is the additional impact mission orientation that the SPO has. This business model is close to a pure commercial one, with the impact programme and the commercial operations very aligned. The clients are all beneficiaries and the impact is direct. The financial sustainability of the SPO is achieved as soon as the commercial business model is proved. We can find this type of business model in SPOs that market products or services for bottom-of-the-pyramid (BOP) populations like Nuru Energy[28].

The hybrid financing instruments most adequate for financing this type of SPOs depend on what stage the SPO is in. In seed-stage the SPO will be detailing its impact and commercial model and will be aspiring to complete a successful pilot. During this period, the most adequate hybrid financing instruments should be recoverable grants and convertible grants. The former for foundations and venture philanthropists interested in launching the SPO and getting their capital back to recycle it in other projects. The latter for long-term impact investors willing to have a stake and participate in the future scaling of the SPO. As the commercial operations and the impact generating activities are very aligned, the risk of mission drift is quite low. So hybrid financing instruments with equity-like features, such as convertible loans, revenue-based loan agreements and revenue royalty certificates, should be considered for the following life-cycle stages. Conventional equity is also an option.

3.2 – Blending business model

In this type of SPO the clients are also the beneficiaries but the aspired long-term impact only exists with additional activities that are not part of the commercial operations, like training and mentoring. The SPO will have extra costs to implement these interventions which will have an impact in reaching financial sustainability. Microfinance is a good example of a Blending business model, where the

[28] Nuru Energy (http://www.nuruenergy.org) produces and commercialises renewable energy lamps for low-income populations in East Africa (Carrick-Cagna et al. 2013).

beneficiaries receive microloans for developing their businesses. Many also need behavioural mentoring and monitoring to control over-indebtedness and the misuse of the capital borrowed. Due to the extra costs of guaranteeing the long-term positive impact, there's a moderate risk of mission drift, as the SPO may tend to discriminate clients with profiles that may lead to higher additional activities costs or even neglect the impact activities to focus on profit maximisation. A good example of how things can go wrong is SKS Microfinance. Founded in India in 1997, it debuted on the Bombay Stock Exchange in 2010. In 2012 it suffered huge losses after the 2011 microfinance crisis in India and an independent report disclosing that it had agents encouraging over-indebtedness and simultaneously using coercive debt-collecting methods.

The hybrid financing instruments most adequate for financing this type of SPOs also depend on what stage the SPOs are in. During seed-stage, the most adequate should be recoverable grants and convertible grants, with the same type of investors as for seed-stage Market Model SPOs. As this business model has a moderate risk of mission drift, it might not be in the best interest of the SPOs to be financed with conventional equity, as the pressure to avoid "expensive" clients might increase. So we suggest financing the next stages with conventional loans, revenue-based loan agreements and revenue royalty certificates. Furthermore, if the additional interventions don't allow the SPO to be financially sustainable, it would be very important to have a grant-making organisation financing them with conventional grants. To avoid misconceptions of where the money goes, it may be in the interest of the SPOs to adopt a differentiated organisational structure[29]: the grant-making organisations would support the not-for-profit units and impact investors would finance the business operations units.

To reduce mission drift and to incentivise support for the more "expensive" but impactful clients it would be an interesting option for an investor to fund a Blending Model SPO with a forgivable loan. The milestone to reach and that would lead to the capital repayment forgiveness could be a medium-term KPI that would unequivocally show the positive impact on the lives of those clients. Looking again at the Microfinance example, the KPI could be a well monitored and pre-defined percentage of "expensive" clients that should be integrated.

[29] In a differentiated organisational structure, the SPO will have two independent units: one to manage the business operations and a not-for-profit unit to manage the additional interventions.

3.3 – Bridging business model

This business model intends to have an immediate impact generation by serving clients and beneficiaries that don't overlap. The SPOs may adopt a complementary needs matching model or a cross-segment subsidy model. The former integrates the clients and the beneficiaries in the same intervention adding value to both while the latter has a high-profit margin client segment (the client) subsidising a similar offer to the low-income segment (the beneficiary). The complementary needs matching model is implemented in SPOs like Auticon[30]. The risk of mission drift is low, as the client and the beneficiary have to be served in the same intervention. The cross-segment subsidy model has an intermediary risk of mission drift because as clients and beneficiaries are served with shared resources and competencies, there is the danger to serve more clients than beneficiaries. An example of an SPO with this model is Aravind Eye Hospital[31].

To avoid mission drift in these SPOs, there's the tendency to invest the surpluses in increasing the impact of the social intervention. This is a typical profile of a not-for-profit organisation and the financing options should be aligned with it. So the hybrid financing instrument most adequate for these SPOs is the forgivable loan, as it is converted totally or partially into a grant when impact KPIs are achieved.

3.4 – Coupling business model

Coupling business model SPOs are the most complex to manage as they have to serve clients and beneficiaries that don't overlap and also need additional activities to achieve the desired impact. The risk of mission drift is high and comes from two sources: the risk of preferring to serve clients rather than beneficiaries and the risk of neglecting beneficiaries that need costly additional support.

[30] Auticon (http://auticon.com) is a German-born IT consulting enterprise that exclusively employs autistic adults as IT consultants. Siemens, Allianz and Henkel are among its clients. It already expanded its services to France and to the UK.
[31] Aravind Eye Hospital (http://www.aravind.org) provides high-quality cataract surgeries to low-income people leveraging the costs with the same service at market price for clients that can afford it.

Consequently, financial sustainability is a difficult challenge to overcome. The Work Integration Social Enterprise (WISE)[32] model exists in some countries and is one of the best examples for this business model. The long-term impact is obtained not just by training and hiring the long-term unemployed people and giving them jobs for two years but by mentoring and training them to find a regular job for after the two-year period, thus facilitating their integration in society. This kind of SPO usually adopts the not-for-profit profile (although for-profit models are not uncommon), with generated revenues invested in increasing the social intervention to avoid mission-drift. As financial sustainability is difficult and sometimes not possible at all, these SPOs are usually financed with conventional grants and, more recently, with Social Impact Bonds (SIBs). The only hybrid financing instrument that would eventually be applicable for these SPOs is the forgivable loan, that will convert into a grant if specified impact KPIs are achieved.

The following table systematises the main characteristics of the analyses done in the previous sections.

Model	***Beneficiaries & clients***	***Impact generation***	***Conventional financing instruments***	***Hybrid financing instruments***
Market	Overlap	Direct	Equity Loans	Seed-stage: recoverable, convertible grants Other stages: RBF, RRC
Blending	Overlap	Indirect	Loans Grants	Seed-stage: recoverable grants, convertible grants Other stages: RBF, RRC, forgivable loans
Bridging	Distinct	Direct	Loans	Forgivable loans
Coupling	Distinct	Indirect	Grants	Forgivable loans

Figure 4 – Business Models and Hybrid Financing Instruments

[32] WISE are SPOs that support long-term unemployed people by training and hiring them for two years, producing goods and services sold on the market.

4 – Hybrid financing instruments and SPOs life-cycle stages

Similar to commercial enterprises, there have been some models proposed to define and conceptualize the life-cycle of SPOs. These models are usually frameworks of evolutionary stages and their main aim is to identify and analyse the different skills, resources and funding options needed at each stage. However, as the main purpose of SPOs is to maximize value creation[33] instead of maximizing value appropriation[34] (Santos, 2012), the focus of their models should be on the cycle of the solution and not on the cycle of the enterprise per se (Santos et al., 2013). Some models have already been created: Clark et al. (2012) suggested the five-stage Model of Pathways and Murray et al. (2010) suggested a six-stage model that takes social innovations from inception to impact.

For this analysis we will use the four-stage model developed and proposed by Santos et al. (2013), as it is broad enough to include the vast majority of solutions proposed by SPOs. This model aims to be a simplified framework that focuses on the development of solutions to societal problems and incorporates the view that design and implementation can't be separated. Figure 5 presents the four proposed stages: The Societal Problem, The Business and Impact Models, The Scaling Up Process and Mainstreaming of the Social Innovation. The following sections analyse each one of these stages.

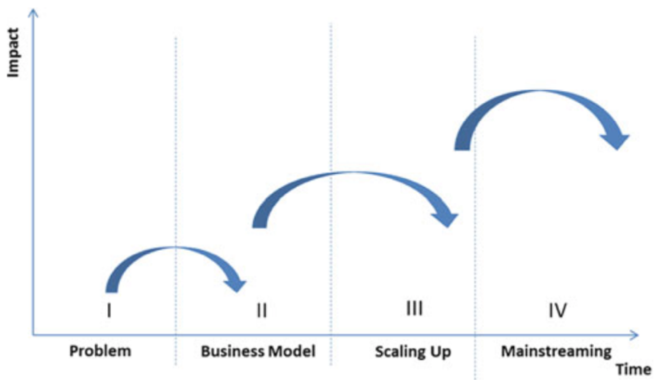


FIGURE 5 – SPOs life-cycle four-stage model (Santos et al., 2013)

[33] Value creation is the value created by the enterprise for the society.
[34] Value appropriation is the value captured by the enterprise.

4.1 – The Societal Problem

In this first stage there's the identification and the objective definition of the social or environmental problem. It's a creation phase, equivalent to seed stage of a mainstream enterprise, where the innovative idea is conceived and developed (Arena, 2017). This process involves a cycle of trial and error while the social entrepreneur attempts to design and implement a solution capable of tackling the problem. Uncertainty is always present and this stage's driving principles are to keep costs low, adapt quickly and focus on understanding deeply the problem and its potential solutions.

In the three-dimensional graphic of risk/ return/ impact, this phase is characterised by low or no impact and by low or no return. It's a high risk phase so traditional grants and donations from philanthropic foundations, corporations and government agencies are usually the most adequate financing instruments (Arena, 2017). They are uncomplicated money with no guarantees needed and no legal procedures attached. Another option is crowdfunding (Arena, 2017). If the SPO is a not-for-profit but is already generating revenues, then traditional financing instruments may not be the most adequate source of financing and we would suggest recoverable grants with zero-return rate. If it is a for-profit SPO, then convertible grants and recoverable grants may be adequate. The former will be mainly provided by high-stake investors looking for big winners and the latter by organisations looking to recycle impact capital.

4.2 – The Business and Impact Models

The SPO reaches this stage after identifying the essence of the innovative solution and validating its pilot in the previous phase. The main objective here is to create a sustainable and replicable business model around the solution previously defined. This phase also needs to develop a sustainable impact model for the solution. The success here is tight to a robust design including the definition of the key resources, the key partnerships, the impact measurement methods and the outcomes to achieve. The solution may have to be adapted to consolidate the models.

The main barriers for getting funded in this stage are the low revenues, the information asymmetry between the entrepreneur and the potential funders and the absence of collaterals in service-provider SPOs (Arena, 2017). The best funders to seek at this phase are impact oriented business angels and social investment focused foundations (Arena, 2017).

Traditional financing instruments have little application at this stage. Most grants are quite inflexible and programmatic and may limit the time available for this stage, which is of essential to guarantee a solid business and impact models. Loans usually require collaterals and guarantees, which are usually not available at this stage. Finally, equity is a too high risk financing option for investors, as the enterprise doesn't yet have consolidated business and revenue models to prove its sustainability. So for this stage we would recommend the application of hybrid financing instruments. For not-for-profit SPOs, the hybrid financing instrument adequate for this phase will depend on the flow of revenues. If they are scarce and the business model suggests that they will always be, then conventional grants will continue to be the most adequate source of capital. But if there are significant revenues, even though not in a constant or predictable way, business angels might become interested in investing and they may use revenue-based loan agreements. A philanthropic organisation may prefer a forgivable loan, as it is more impact oriented than financial oriented. In this phase, a for-profit SPO with a potentially scalable business model will attract equity investment, convertible loans, revenue-based loan agreements and revenue royalty certificates. The financing solution will also depend on the risk of mission drift of the business model defined. If it is moderate or high, the founders will tend to reject any equity participation, to avoid the risk of no exit options.

This phase is iterative, with regular improvements in the business and impact models to achieve a robust solution in both dimensions before the scaling phase that follows and which may require larger financing needs (Arena, 2017).

4.3 – The Scaling-Up Process

This stage involves scaling the solution towards greater impact. Scaling may be done in two dimensions: the SPO may scale up by replicating the same services or products in new locations and geographies or the SPO may scale deep by achieving greater impact at a local level. While scaling up is simple to understand by investors, scaling deep is not usually well accepted as it may mean that returns will not grow. Often the SPO will alternate between focusing on scaling up, focusing on scaling deep and back to focusing on scaling up.

During the scaling stage the SPO has to focus on the organisational structure and manage its growth. Commercial debt is probably the main source of capital for this phase as most social impact funds have minimum equity tickets much larger than what is needed (Arena, 2017). Individual contracts of convertible loans and revenue-based loan agreements are other options among the hybrid financing instruments. From this stage on, it is easier to attract more and more diverse impact investors if the SPO generates revenues.

4.4 – Mainstreaming of the Social Innovation

This stage involves embedding the solution in the societal institutions, creating systematic change by changing concepts and mind sets. Depending on the problem and the solution, this may mean creating the pathway to spread the innovation, influencing policies by challenging the institutions that participated in the creation of the problem, creating and developing open platforms such as Khan Academy and Wikipedia or fostering adoption such as Microfinance.

Only a narrow percentage of social innovations reach this stage as there are many obstacles in the way. Lack of sustainability at scale, inadequate management and difficulties in getting the right financing in due time are just some of the issues that prevent most social innovations to reach this stage. Microfinance and Wikipedia are two cases that should be in all social innovators minds as successful stories that mainstreamed.

To be successful at this stage, the SPO has to focus on political and resource mobilisation skills. The financing needs are greater and most times aren't easily predicted. Traditional financing instruments like grants and loans aren't adequate anymore as they are usually narrowly focused and may constrain the options. We believe that most funding should come from investors whose main goal is totally aligned with the main objective of this stage: the systematic change and the spread of the solution. From the hybrid financing instruments previously analysed, the most adequate for this stage is the forgivable loan, as it is the one mainly impact-oriented.

The following table systematises the main characteristics of the analyses done in the previous sections.

Stage	***Conventional financing instruments***	***Hybrid financing instruments***
The societal problem	Grants	Recoverable grants, convertible grants
The business and impact models	Not-for-profit: grants For-profit: equity	Not-for-profit: RBF, forgivable loans For-profit: convertible loans, RBF, RRC
The scaling-up process	Loans	Convertible loans, RBF
Mainstreaming the social innovation	Loans	Forgivable loans

Figure 6 – Life-Cycle Stages and Hybrid Financing Instruments

5 – Conclusions

In this thesis we synthesised the recent developments and applications of single-investor and single-contract hybrid financing instruments in the Impact Finance space (as opposed to more complex multi-funder and blended instruments financing deals). These hybrid financing instruments are combinations of traditional grants, debt and equity, and have been evolving and adapting to the financing needs of Social Purpose Organisations' new business models and life-cycle stages.

We analysed each instrument's characteristics, its constrains and most adequate applications. We discussed each one of these novel financing instruments from the perspectives of the investor and the investee, always bearing in mind the investor's frame of risk/ return/ impact and the investee's purpose of maximising the value creation for society.

We believe that traditional financing instruments like grants, loans and equity will continue to have applications in Impact Finance, alongside the hybrid instruments discussed in this thesis, as well as more complex financing mechanisms. All of them will participate in the continuous development and enrichment of this growing area.

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