ENERGY
CATALYST

Investment Guide: Special Instruments

June 2020

Innovate UK

UKaid from the British people

Investment guide: Special instruments

Investors may use special investment instruments to facilitate investment into businesses, rather than traditional financing through senior debt and equity. This guide outlines the key terms to be aware of for different special instruments, as well as the benefits and risks associated with each. Throughout the business life cycle cashflows change, and this guide will expose the reader to alternative sources of capital that can reduce the cost of external financing to the business.

Limitations of debt and equity

Stages of the business cycle

The cashflows associated to each stage of business development, from early to growth and to mature stage, enable access to different types of external investment (see Figure 1).

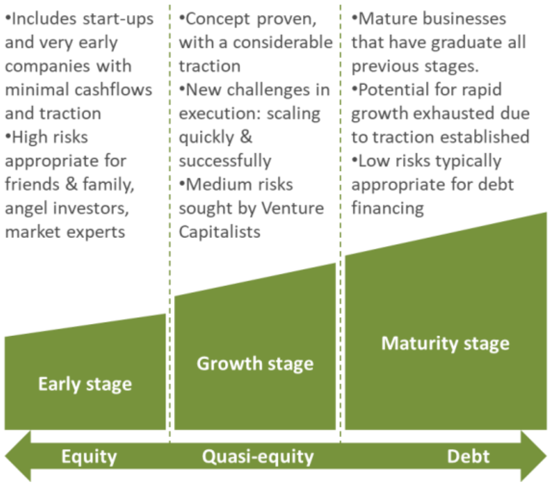

Figure 1: Financing and the business life cycle

At the **early stage**, companies may have low or unstable cashflows. This requires a source of capital that does not strain business liquidity, but rather enables investment in growth. For instance, in an equity investment a company may sacrifice a portion of ownership in the form of common shares in return for capital. Equity returns to the investor are driven by share price appreciation and dividends, payable only when company cashflows and profits allow.

In the **growth stage**, companies are faced with unique challenges such as scaling, refining products and establishing regular cashflows. To overcome these challenges, businesses may look to raise capital with characteristics of both equity and debt that best service their needs.

At mature stage, companies will have established a proven business model with predictable cashflows. At this point, debt financing may be best suited as the lowest cost external capital available to the business.

Equity investment overview

A company may raise financing through a sale of ownership in the business. This is referred to as receiving **equity** investment, with investors having a claim on the company's net assets.

Equity investor returns are realised through dividend payments and share price appreciation. **Dividends** are periodic payments that return the profits generated by the business to shareholders. These are typically only paid once a business is profitable and has excess capital available after continued investment into the business. Returns from share price appreciation may be realised when ownership is sold back to the company or to other investors.

Equity investment is perceived as high risk, with dividend and share price appreciation not guaranteed and shareholders retaining a claim on company assets only after debt holders and employees have received their outstanding obligations. As such, whilst equity investment does not draw cash from a business unless it is available, the projected returns to investors will be higher than debt if company performance is realised.

Despite this being a popular method of generating capital, raising equity investment can be time consuming and will require negotiation on the value of the business, which can be difficult to determine for early stage businesses.

Debt investment overview

Debt financing is a contractual agreement between a borrower (the business) and a lender, where the borrower is required to repay the amount (principal) borrowed at the cost of interest charged. Debt may be raised from financial institutions, such as banks or debt investors, as loans, or for more mature companies, as bonds issued by the company to investors.

For a company, the advantages of debt include that the cost of this external capital is known to the business and clearly set out in the terms of investment. In addition, debt financing is typically lower cost than equity financing because of lower perceived risk (attributed to seniority and collateral), as well as tax deductions available for interest payments. Lastly, negotiation of debt terms is typically faster than for equity, with lower levels of due diligence.

In raising debt, companies and investors will look to ensure the company is able to meets it obligations and not over-leverage the business. In particular, a company should be aware of debt covenants in the agreement that may restrict management behaviour, and the claims resulting from seniority, that enable debt investors to realise company net assets before shareholders in the event of a debt default. Seniority provides the ranking of different debts in the event of liquidation. Senior debt will be paid ahead of other debts. Subordinate debt ranks below senior debt. Additionally, debt might be secured against specific company assets or otherwise referred to as unsecured debt. Seniority and securitisation are set out in the debt terms, and when new financing is sought it may require negotiation with existing debt investors.

Special instruments overview

Investors have developed special instruments to mitigate the limitations of equity and term debt, and as a result they often share aspects of both debt and equity. Broadly referred to as **quasi equity**, the high level spectrum of special instruments available are set out in Figure 2.

Asset financing

Asset financing leverages a company's balance sheet assets to raise capital. One form of asset financing leverages a newly acquired asset as security for a loan to purchase that asset. Asset financing may also include raising debt against existing business assets, such as short-term investments, or existing plant and machinery.

For businesses, asset financing may provide fast access to capital on senior debt terms at lower cost than other financing. In addition, the lender may only have rights to recover the asset itself rather than force a business into full liquidation in an instance of non-payment. As such, businesses pursuing asset financing will need an asset base that is perceived by investors to be accessible and liquid (for resale) in case of non-payment.

For investors, the ability to secure the investment with specific collateral reduces risk, by ensuring that they will recoup some of their investment in case of liquidation.

Inventory financing

Companies may be able to access inventory financing to purchase products for sale at a later date. Typically extended as a line of credit by specialist investors or direct suppliers, it enables a business to secure inputs for future sales, often using the inventory itself as security for the line of credit. Inventory financing usually has a credit limit and may have a repayment schedule aligned to the expected time frame for sale of the inventory.

Inventory payables refer to a line of credit provided by vendors who sell products on credit and only require payment after a defined period of time (a 30-day payable period is a common example).

For businesses, this may be a cost-effective way of accessing essential inputs to scale while matching repayment requirements to their own cash conversion cycles. It also aligns investor and company interests by providing financing for secured assets that directly translate into revenue that can be used to repay the line of credit. For suppliers who extend inventory financing, this creates a market for their own products, supports stronger customer relationships, and may provide additional income via interest payments.

Revolving credit facilities

Revolving credit facilities, provided by one or more banks, enable businesses to access credit on short notice up to a pre-agreed amount. These agreements allow businesses to draw-down on debt when needed and repay the debt when cashflows allow, with interest paid only on the amount of credit that has been used.

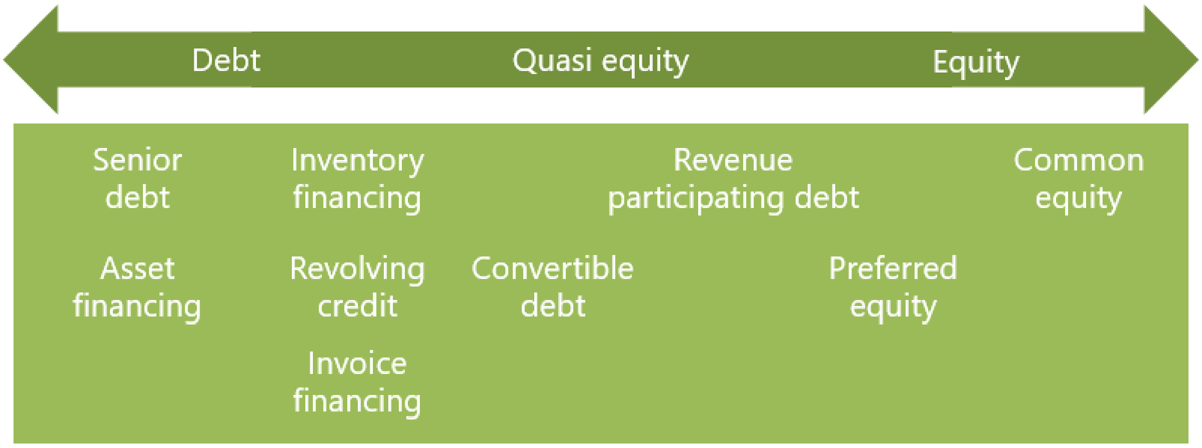

Figure 2: Spectrum of investment instruments

In addition to interest, a company may need to pay a recurring fee for access to facilities, and if extended by the company's bank, may be subject to automatic repayment when the company's main cash balance account crosses a specified threshold.

Revolving credit facilities provide a reliable form of short-term borrowing for businesses and enable a company to manage cashflows. They are less appropriate for long-term investments and may only be accessible for mature businesses with stable cashflows.

Invoice financing

Invoice financing, as either invoice factoring or invoice discounting, is the process of selling outstanding customer invoices to third parties. Businesses that extend credit to customers, or who have long payment terms, record sales as receivables until cash payment has been made. These receivables can be sold to third parties at a discounted rate.

Invoiced factoring will transfer the collection of receivables to the third-party; in invoice discounting, the business itself retains responsibility for payment collection. Both types of invoice financing can be either **recourse**, where the business itself carries the risk of non-payment, or **without recourse**, where the third party carries non-repayment risk.

For businesses, invoice financing may provide a route to addressing working capital need by realising cash from sales faster.

Convertible debt

Convertible debt is a hybrid instrument, initially issued as debt with debt terms, that provides the holder with the right to convert the debt into equity on predetermined terms. This conversion may take place after a period of time or on a liquidity event, such as subsequent capital raise.

Similar to term debt financing, convertible debt includes key terms such as tenor, rate of interest, repayment schedule and fees. However, it also includes conversion terms like **conversion price** (price per share at which the debt exchanges for shares), **conversion value** (the value of debt converted) and **conversion ratio (**the ratio of debt to shares). Convertible debt terms also define when debt can be converted to equity (e.g. through a liquidity event) and may include a **valuation cap** that limits the maximum valuation of the business at conversion.

Businesses may be able to negotiate convertible debt terms more quickly than for equity investments, often deferring the valuation of the business to a later financing raise. Additionally, convertible debt does not typically require short- or medium-term cashflows, and if conversion takes place, it will not require cashflows at all if interest accumulates over time onto the value of debt rather than being paid. Though businesses should consider that until converted, convertible debt remains on the balance sheet as debt and increase business leverage, after conversion some control of the business will be lost to the original shareholders.

For investors, convertible debt holds less risk than pure equity, remaining as debt with debt obligations that will be repaid ahead of equity holders in the event of a liquidation. Additionally, the investors typically retain the right to determine if conversion happens or if investment is repaid per the defined debt schedule. If debt is converted, it compensates investors for taking a higher risk than for term debt, by providing equity returns upside.

Revenue participating debt

Revenue participating debt provides equity-like upside to lenders in the event of business outperformance without the transfer of ownership in the business.

Typically a form of subordinate debt, revenue participating debt is likely to include specific terms defining revenue participation such as the agreement timeframe, the percentage of revenue share and a **payout cap** (typically based on the amount invested, this limits the total revenue shared over the agreement time frame). In addition, revenue participating debt may have standard debt terms on tenor, interest and repayment periods.

For businesses, revenue participating debt aligns company and investor interests, requiring smaller payments during periods of underperformance and higher payments when the company is outperforming. In addition, this may be an easier form of investment to negotiate compared to equity, and it does not result in a loss of control in the business. However, revenue participating debt is still classified as debt, increasing the company's debt-to-equity ratio, and may result in a higher long-term cost to the business relative to term debt.

For investors, this instrument provides equity-like potential upside to investment. However, it is likely to be perceived as higher risk than term debt and may be restricted to companies that can demonstrate a track record of revenue growth. Investors may look to offset risk when negotiating revenue participating debt by pursuing longer debt terms and a board seat.

Preference shares

Preference shares are a form of equity investment that ranks ahead of common equity for dividend returns as well as for claims on residual assets if liquidation occurs.

Investment in preference shares will likely include standard equity terms such as **valuation** (share price) and the number of **shares** purchased. In addition, preference shares will likely include specific terms on **dividend yield** (to be paid ahead of any distribution to common shares and that accumulate in years when dividends are not paid), **liquidation preference**, **voting rights** and **board seats**. Preference share terms are typically presented on an "as converted basis" with a defined ratio at which preference shares are converted to common shares.

For businesses seeking equity investment, the sale of preference shares may be the only class of share sought by new investors. Negotiating equity can be time consuming and will require a business valuation. However, preference shares will not draw cash from the business unless the business is able to pay dividends. Further, preference shares are reported as equity, reducing leverage and enabling businesses to access greater amounts of debt.

For investors, preference shares mitigate some of the risk of minority share ownership in a business, whilst potentially providing higher returns than debt.

Mezzanine financing is a broad term used to refer to quasi-equity investment instruments. Subordinate to senior debt but senior to common equity, mezzanine financing is typically structured to provide a higher return to investors (e.g. through revenue share, dividends or equity conversion) but with a higher risk relative to term debt.

Other special instruments

In addition to the previously described special instruments that fall along the debt-equity spectrum, businesses may encounter other alternative funding mechanisms when pursuing financing.

Sale and leaseback

In a sale and leaseback, a business sells an asset to a third party and leases the asset back for a specific amount of time. Typically used on large fixed assets such as land or facilities, this enables the business to realise a large cash payment in return for smaller subsequent payments. The terms of a leaseback typically include the duration of the lease, as well as the frequency and amount of lease payments.

This arrangement enables a business to realise cash from its asset base whilst still retaining access to the asset. However, consideration should be given to the implicit interest rate of the leaseback and ultimate cost of ownership over lease and tax deductions available for depreciation or interest payment associated to lease agreements.

Green bonds

Green bonds are a form of debt financing issued by a company to raise capital for projects focused on protecting the environment and working against climate change. Though similar to term debt in terminology and structure, green bonds differ in that they are often offered at below-market interest rates.

Off-balance sheet financing

Off-balance sheet financing is a tool used to separate the specific assets and liabilities of a business from those that appear in the company balance sheet. This is done through the use of a **special purpose vehicle** (SPV), a subsidiary company that is established to take ownership of the assets and liabilities that are not wanted on the books of the parent company. Securities (bonds/loans) are then issued by the SPV, backed by the assets, through a process known as **securitisation**.

This process is useful in that it separates these assets and liabilities from the holding company. The responsibility of paying the interest payments falls on the subsidiary, and therefore protects the cashflows of the parent company.

Crowdfunding

Crowdfunding generates capital by pooling smaller investors, or backers, to finance a business or project. Some crowdfunding platforms provide equity or debt products as aligned to those instruments previously outlined, while others may be rewards-based, providing access to benefits such as purchasing products at cost. Rewards-based crowdfunding may provide concept-stage businesses with access to financing that would otherwise be unavailable. More information on crowdfunding is available in the investment guide on this topic.

Hedging instruments (derivatives)

Hedging instruments are tools used to control the level of risk that a business or investor is exposed to by providing downside protection on a specific external variable. This might include safeguarding against fluctuations in interest rates, exchange rates or commodity prices.

Tools including futures, forwards, options and swaps involve contracts with third-party institutions that provide the business or investor with certainty about what rate will be applied when the returns on an investment are due. For instance, a business that has issued invoices in a foreign currency from an international client may arrange for a contract with a bank to settle repayments at a fixed exchange rate in the future, mitigating risk of adverse currency fluctuations for a fixed fee.

Whilst hedging tools can help businesses better plan their cash flows, they can be sophisticated and expensive and may not be appropriate or accessible to earlier stage businesses.

Conclusion

For businesses seeking financing, special investment instruments present an alternative to traditional term debt and equity funding. While these investment types may require additional effort to find investors, they can provide financing that aligns with businesses' unique needs, often balancing aspects of term debt and equity.

References and further reading

Crowdfunding
https://www.energy4impact.org/news/new-report-explores-role-crowdfunding-raising-finance-energy-access-businesses-and-projects

Mezzanine financing
https://corporatefinanceinstitute.com/resources/knowledge/finance/mezzanine-financing/

Off balance sheet financing/securitization
https://www.ifc.org/wps/wcm/connect/07d1dce0-3e5f-4254-9d8c-fc49d1ba8327/Securitization.pdf?MOD=AJPERES&CVID=lkk-0Op

Investment opportunities
https://www.gogla.org/type/investor

Green bonds
https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/investor+relations/ir-products/ifc+green+bonds+process

Useful contacts

The Global Impact Investing Network (GIIN)
One Battery Park Plaza, Suite 202,
New York, NY 10004
USA
+1 646 837 7430
https://thegiin.org/
info@thegiin.org

GOGLA (Association for off-grid solar industry)
Arthur van Schendelstraat 500A
3511 MH Utrecht
The Netherlands
+31 304 100 914
https://www.gogla.org/
info@gogla.org

Sunfunder
Workify 11th floor
Wood Avenue Plaza, Wood Avenue /
Argwings Kodhek Road junction
Nairobi
Kenya
+254 704 735 467
https://www.sunfunder.com/

Please contact your Client Relationship Manager if you want help with introductions to specific individuals within these institutions.