

## Case Study

### Impact Investment Structure

We are in West Africa in late 2013. Fund Gulf International is considering an investment into a local rubber producer. The producer sources its raw material from local farmers in the region; and exports most of its production into Western Europe.

The Company was founded in 2002 as a raw material supplier for industrial rubber companies. In 2008, it expanded into natural rubber transformation by investing in a coagulum processing plant with yearly output of 18000 tons of granular rubber.

An investment of €5m is needed to double the production capacity to 36 000 tons; as well as allowing the Company to better secure its raw material source with a 5,000 ha planting project.

Also planned is (i) training local farmers in best practise cultivation techniques plus other community institutions such as a local school and a village electrification project, (ii) building a waste water treatment plant, (iii) sponsoring a local sports teams, (iv) building an access road around the expanded industrial area to allow delivery trucks as well as local residents better access.

The four projects above were developed by an NGO with technical assistance funds, who has a relation with the Company and sees these projects as essential parts of the investment. As a commercial PE fund, GI is rather confused by all these extra expectations which seem to go beyond its scope of investment. There is pressure on GI from the NGO, local government and others to include these projects into its investment.

GI meets a US philanthropic fund, who indicates that it understands GI's concern, in particular its fiduciary duty to its LPs to maximise returns. The philanthropic fund suggests that if GI can come up with a suitable proposal, it will be willing to play some form of "first loss" role, in exchange for GI guaranteeing to proceed with the social projects.

GI now studies a suitable structure. The Company needs an investment of €5m. One of the constraints is that the founding entrepreneur insists on going no lower than 51% of the ordinary voting shares.

Based upon its assessment of the market, GI believes that the Company can be sold for 5 X EBITDA – DEBT at the end of 4 years.

#### Company mid range plan

Working with management, GI has created a four year forecast of the Company's financials, including the €5m investment, based upon the constraints given.

The mid range scenario, based upon average assumptions, is the following:

West African Rubber Co. (€m)					
	2013	2014	2015	2016	2017
Sales	15.00	28.50	31.35	33.23	35.22
y-o-y growth		90.00%	10.00%	6.00%	6.00%
Gross Profit	3.50	7.98	9.09	9.97	10.57
as % sales	23.33%	28.00%	29.00%	30.00%	30.00%
EBITDA	0.60	1.43	1.57	1.66	1.76
as % sales	4.00%	5.00%	5.00%	5.00%	5.00%
PAT	-0.23	0.29	0.94	1.33	2.11
as % sales	-1.53%	1.00%	3.00%	4.00%	6.00%

Based upon these forecasts and the 49% constraint, GI estimates its return. Cash flow to equity is assumed to be equal to PAT, for simplification purposes.

Cash flow to equity	-0.2	0.3	0.9	1.3	2.1
Exit valuation (5XEBITDA-DEBT)					6.3
Maximum ownership	49.00%				
Cash flow to value	-5.0	0.1	0.5	0.7	4.1
Investment	5				
IRR	2.03%				

If GI is to provide €5m as equity, for a 49% stake, the return expected will only be 2%, which is unacceptable for GI.

GI's calculation under a pessimistic scenario (shown below) is an even worse -16%.

Thus on this basis, GI would not proceed with the investment.

#### Involvement of philanthropic fund in structure

GI makes an agreement with the fund to invest €2.5m, as redeemable preference shares with a 3% cumulated coupon. A first loss mechanism is added, according to which the philanthropic fund will be repaid at the time of exit, the lower amount of (i) its principal and cumulated interest or (ii) 20% of the exit proceeds to GI.

Introducing this structure into the deal structure, results in the following.

subordinated redeemable preference shares with coupon					
Amount	2.5		2.81	Principal with interest	
Interest rate	3%		0.83	20% of exit proceeds	
FV					0.83
Cash flow to value	-2.5	0.1	0.5	0.7	3.3
Investment	2.5				
IRR	18.66%				

In the mid range plan, GI earns a return of 19% on an investment of €2.5m. The philanthropic fund gets back €0.83m on its investment of €2.5m, effectively subsidising the social programs.

## Outcome under other scenarios

Under an optimistic scenario, the expected outcome is as follows.

West African Rubber Co. (€m)					
	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
Sales	15.00	30.00	37.50	46.88	51.56
y-o-y growth		100.00%	25.00%	25.00%	10.00%
Gross Profit	3.50	8.40	12.00	16.41	18.05
as % sales	23.33%	28.00%	32.00%	35.00%	35.00%
EBITDA	0.60	3.60	5.63	9.38	10.31
as % sales	4.00%	12.00%	15.00%	20.00%	20.00%
PAT	-0.23	0.90	1.88	3.28	3.61
as % sales	-1.53%	3.00%	5.00%	7.00%	7.00%
Debt	2.5	2.5	2.5	2.5	2.5
Debt/EBITDA ratio	4.17	0.69	0.44	0.27	0.24
Cash flow to equity	-0.2	0.9	1.9	3.3	3.6
Exit valuation (5XEBITDA-DEBT)					49.1
Maximum ownership	49.00%				
Cash flow to value	-5.0	0.4	0.9	1.6	25.8
Investment	5				
IRR	59.69%				
subordinated redeemable preference shares with coupon					
Amount	2.5		2.81	Principal with interest	
Interest rate	3%		5.16	20% of exit proceeds	
FV					2.81
Cash flow to value	-2.5	0.4	0.9	1.6	23.0
Investment	2.5				
IRR	89.68%				

In this case, GI could consider modifying the deal structure on the upside in favour of the philanthropic fund, given that its return is kicked up from 60% to 90%.

In the pessimistic scenario, the outcome is as follows.

West African Rubber Co. (€m)					
	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>
Sales	15.00	22.50	27.00	32.40	38.88
y-o-y growth		50.00%	20.00%	20.00%	20.00%
Gross Profit	3.50	4.50	5.67	7.13	9.33
as % sales	23.33%	20.00%	21.00%	22.00%	24.00%
EBITDA	0.60	0.68	0.81	0.97	1.17
as % sales	4.00%	3.00%	3.00%	3.00%	3.00%
PAT	-0.23	0.00	0.54	0.65	0.78
as % sales	-1.53%	0.00%	2.00%	2.00%	2.00%
Debt	2.5	2.5	2.5	2.5	2.5
Debt/EBITDA ratio	4.17	3.70	3.09	2.57	2.14
Cash flow to equity	-0.2	0.0	0.5	0.6	0.8
Exit valuation (5XEBITDA-DEBT)					3.3
Maximum ownership	49.00%				
Cash flow to value	-5.0	0.0	0.3	0.3	2.0
Investment	5				
IRR	-16.20%				
subordinated redeemable preference shares with coupon					
Amount	2.5		2.81	Principal with interest	
Interest rate	3%		0.40	20% of exit proceeds	
FV					0.40
Cash flow to value	-2.5	0.0	0.3	0.3	1.6
Investment	2.5				
IRR	-3.55%				

In the pessimistic scenario, GI suffers a negative return of -3.5%. The philanthropic fund gets back €0.4m.