Miller Center
for Social Entrepreneurship

Demand Dividend:
Creating Reliable Returns in Impact Investing

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Demand Dividend is a debt vehicle designed to improve the repayment cycle for impact investors and ease capital access for social enterprises.

Demand Dividend grew out of the need to find alternatives to debt, convertible debt, and equity as funding mechanisms for social enterprises. Demand Dividend has four key features:

Key Characteristic	Demand Dividend	Equity	Debt	Revenue Royalty
A structure designed to enable successful capital exit (a "round trip")	X		X	X
Payments linked to the enterprise's ability to pay	X			
A return profile commensurate with investor risk in frontier enterprises	X	X		X
Incentives to align investor and entrepreneur interests	X			

Demand Dividend is designed to enable investors to generate a reliable, reasonable return while allowing social entrepreneurs to maintain control and efficiently deploy capital.

Impact Investing Issues

Impact investors targeting small, growing businesses (SGBs) face a variety of issues. In our view, the most relevant are:

- Underperformance on the return promise.
  - Exits from equity or convertible debt deals have been rare,
  - Reliance on the venture capital approach of generating a few "big wins" has not materialized, and
  - Investable enterprises have been "screened out" due to high portfolio return hurdles.

- Misalignment of investor and SE incentives.
  - Exit preferences may be in conflict: the investor prefers a buyout or IPO while the SE desires family or community control, and
  - Views may diverge on the importance of reliable financials and meeting projections.

- Scarcity of capital targeting frontier economy SGBs.
  - Traditional debt or equity instruments are not appropriate; debt does not compensate for risk, and equity lacks a defined liquidity event, and
  - Relatively fixed due diligence costs are hard to justify for $20,000 to $250,000 investments.

While no one vehicle or approach can address all these issues, we believe Demand Dividend is a tool that improves the ability of impact capital providers to invest in early-phase SGBs and deliver on their return promise to investors.

The Demand Dividend Solution

Demand Dividend is a variation on a debt royalty structure, modified to fit the realities of investing in frontier economy social enterprises. Demand Dividend has four central features:

- Payments tied to cash flow;
- A “honeymoon period” to allow capital to go to work;
- A fixed payoff amount (multiple of initial investment) to:
    - Compensate the investor for risk, and
    - Incent the entrepreneur to extinguish the obligation; and
- Term sheet covenants and attached business plan focused on cash to align incentives

Payments based on free cash flow: Demand Dividend holds a claim on a minority of cash flow from operations (25% to 50%) – leaving most of the cash flow available for reinvestment. Payments are first applied to term debt equal to the amount of the initial investment. Unlike royalty-based financing which pays based on revenue, Demand Dividend requires payment only if operating profits are generated. This relieves the burden of servicing debt when there is no operating income.

An abeyance (“honeymoon”) period: The repayment obligation is deferred to allow investment proceeds to accelerate enterprise revenue and profit growth. Duration could range from 10 to 24 months.

A fixed total obligation: The claim on enterprise cash flow remains until a multiple (1.5 to 3x) of the initial investment has been paid. This multiple of investment compensates the investor for the risk associated with SGBs, frontier markets, and subordination to asset-backed credit. The obligation extinguishes when payment is complete.

Business model as an integral part of term sheet: A cash flow focused financial forecast is attached to any Demand Dividend term sheet. This forecast, equal to the length of the debt term, ensures alignment of investor and entrepreneur expectations and reduces the potential for accounting irregularities due to associated covenants.

These elements balance the needs of investors and social entrepreneurs. With a claim on cash flow investors receive a reliable return stream, and are reasonably compensated for risk by receiving a multiple of their investment as final payoff. The honeymoon period allows entrepreneurs to accelerate their business to positive cash flow, and the fixed payoff amount provides an incentive to repay the Demand Dividend to maintain control of their company.

Detailed Demand Dividend definitions and covenants are illustrated in a sample term sheet: http://bit.ly/ZrO6AV.

Demand Dividend In Action

Demand Dividend is primarily designed as a capital infusion to propel social enterprises to positive cash flow. We have modeled use of Demand Dividend on both historical and projected social enterprise financial data. To clarify Demand Dividend components, below is an example of an investment in a composite service enterprise.

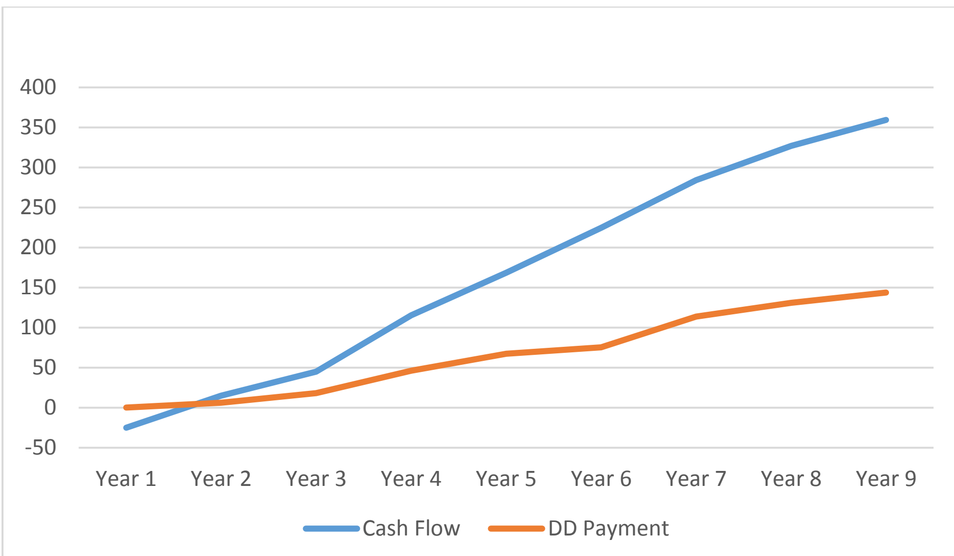
The key parameters of a Demand Dividend are the debt obligation, the payment source, and the total obligation.

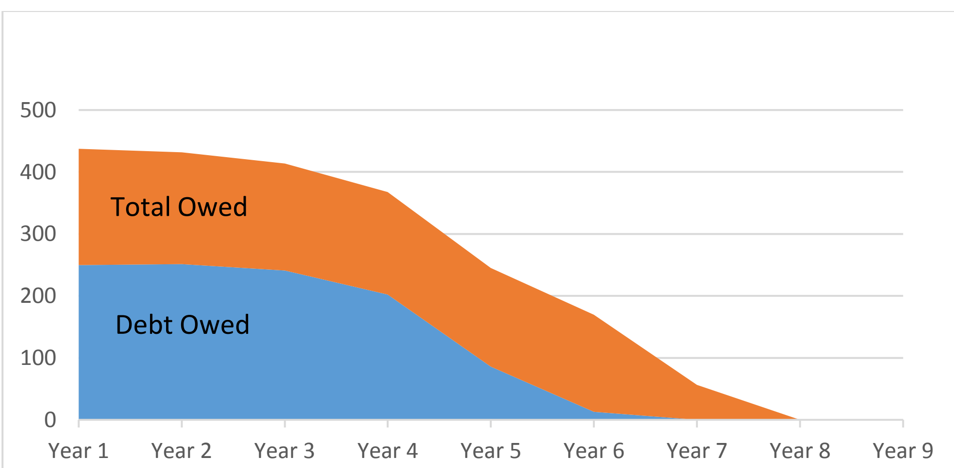
Service Company Hypothetical Demand Dividend Terms

Initial Investment	$250,000
Debt Obligation Terms	3% interest, 6 year term
Payment Structure	40% of free cash flow, 1 year honeymoon period
Total Obligation	1.75x initial investment ($437,500)

In year 0 (the time of initial investment) the company has $100,000 in sales. Based on composite historical data, a Demand Dividend investment would accelerate company sales and enable cash flow breakeven late in year 2. As the charts below show, the debt is paid in the first quarter of year 7, and the total obligation is paid early in year 8. The IRR of the investment is 10%.

Service Company Demand Dividend Outcome
(modeled from historical composite data, $000)





Based on our data, a product-based company has a different Demand Dividend payback trajectory. Product companies may require a larger initial investment (relative to starting sales) than a service company and a longer honeymoon period. Cash flow breakeven occurs later, but once begun, Demand Dividend payback is faster due to high margins at scale. The table below outline a preliminary sensitivity analysis of Demand Dividend returns.

Demand Dividend Sensitivity Analysis

Multiple of Initial Investment	Service Years to Payoff	Product Years to Payoff	IRR
1.25	7	6	4%
1.5	8	6	7%
1.75	8	7	10%
2	8	7	12%
2.5	9	8	15%

Terms: 3% interest, 6 year debt term, 40% of cash flow to Demand Dividend

Demand Dividend Advantages

At its core, Demand Dividend provides two important advantages versus other traditional investment vehicles:

- A reliable promise of return and exit, and
- A structure that aligns investment repayment with actual cash generation.

Traditional debt, if available to a social entrepreneur (SE), is often a burden for small growing businesses. With Demand Dividend the financial structure is synchronized with the business model (honeymoon period, payments based on cash generated) and investor oversight and governance is improved. When compared to the usually long and uncertain holding periods for equity (or convertible debt that often defaults to equity), Demand Dividend:

- Provides capital return during the investment period and an explicit exit mechanism,
- Avoids the complexity of estimating company valuation, and
- Allows entrepreneurs to retain greater operational and financial control.

In addition, Demand Dividend, as part of the negotiation of the term sheet, forces an entrepreneur and investor to agree upon a cash flow definition and forecast. The parameters of the Demand Dividend can be tuned to the SE's business model and the investor's required return. From the outset the SE knows the amount required to retire the Demand Dividend and understands the necessity of creating positive cash flow. The investor gives the SE a chance to succeed, with a honeymoon period and payments based on business velocity, but retains a claim to cash as generated.

Demand Dividend also causes the investor and entrepreneur to choose the correct investment vehicle for the maturity and likely outcomes of the business. If an SE cannot make a reliable cash forecast, or if accounting skills are not advanced enough to account for cash in a reasonable time interval, then perhaps the enterprise is not ready to make a promise of investment return. Investors could then focus on capital provision in a form closer to a grant, or understand that any return is likely long term with a highly uncertain IRR.

We have identified a variety of hybrid securities with characteristics similar to Demand Dividend. The most similar are Revenue Royalty agreements, Profit Participation Loans, and Grant Refund mechanisms. The most widely used structure appears to be Revenue Royalty, where traditional debt is combined with payments based on a percent of revenues. These structures differ from Demand Dividend in an important way: the debt payments are not based on the enterprise's ability to pay. The Revenue Royalty is a "kicker" to traditional debt – the percent of revenues taken is in addition to the time-based debt payments. From an accounting standpoint revenue may be easier to measure than cash. However, an enterprise may grow revenue without generating cash. And since cash is required for repayment, focus on cash flow reinforces the discipline required for reliable repayment.

Demand Dividend and Negative Outcomes

When a social enterprise falls far short of its financial plan investors have a variety of options with Demand Dividend:

- Extend terms: lengthen the honeymoon period or debt repayment term,
- Renegotiate the Demand Dividend note (change the total obligation multiple and/or percent of cash flow), or
- Replace the note (potentially with a new Demand Dividend).

Due to the variable nature of Demand Dividend payments, if an enterprise temporarily misses cash flow goals there is no immediate need to renegotiate terms. Cash flow based payments will rebound as the enterprise recovers. However, when prospects for cash flow recovery are low, then renegotiation of Demand Dividend terms will likely be required. An advantage of the Demand Dividend construct is that investors have a variety of levers and options to create a beneficial outcome.

Although payments with Demand Dividend are variable, the base debt repayment has a fixed term. Normally at the end of the debt term the enterprise will have accumulated sufficient cash to repay any principal not paid off with prior payments. If the enterprise is unable to repay the debt at term end, investors can extend the debt repayment term – a likely outcome if the company is generating cash, but below plan.

If the enterprise is performing significantly below plan, then investors have a variety of options. Demand Dividend has multiple terms for renegotiation: honeymoon period, percent of cash flow, debt term and interest rate, and multiple of initial investment owed. Investors can choose to renegotiate the terms of the existing Demand Dividend. Or a new Demand Dividend can be put in place to pay off the original note and craft a new note better aligned with the enterprise's outlook.

Demand Dividend as part of the Investment Continuum

The goal of a vehicle like Demand Dividend is to increase the financing options available to investors and entrepreneurs. Selecting a financing vehicle that matches a company's business model and stage of development helps ensure social enterprise success.

Demand Dividend is best suited for companies beyond the proof-of-concept stage with a reasonable line of sight to positive cash flow. Investments to increase manufacturing capacity, add new distribution channels or geography, or expand a product line would be typical uses for Demand Dividend. A company three years from positive cash flow or with high product development or service model risk is probably not well suited for Demand Dividend.

Use of Demand Dividend is not limited to traditional social enterprises. Project-based financing can also benefit from use of Demand Dividend. For example a community-based water sanitation project will generate reliable cash flows after an initial investment. Or a farming co-op storage facility can improve farmer cash flow with higher average realized price. Often these community entities cannot obtain bank debt, are too small for NGO attention, and do not create the type of value that would allow an equity exit. In these circumstances the Demand Dividend model may allow impact investors to fund beneficial community-based projects.

Summary

We believe the Demand Dividend structure is an important model to allow impact funds to deliver returns to their investors while also supporting the goals of social enterprises. We look forward to evolving and deploying Demand Dividend in partnership with the impact community.