NESsT INVESTMENT CASE STUDY

Why Co-Invest?

Creating Co-Investment Opportunities for Social Enterprise Success
Why Co-Invest?

Social enterprises use market-based solutions to solve critical social problems. They create jobs for local economies, make connections to regional and global markets, and increase access to critical goods and services for underserved communities. However, they face several barriers preventing them from achieving financial success and impact at scale. Chief among those is that there are few social investors and financial instruments available to fund their consolidation and growth – especially in Central and Eastern Europe (CEE) – as most financial support in the region is short term, grant based and focused on start-ups.

Social impact investing is growing rapidly in Europe and globally, yet social entrepreneurs face difficulties in raising capital at levels below USD 250,000. Most available impact investment demands commercial returns, making it out of reach for early-stage social enterprises. Social enterprises are also generally not eligible for existing commercial financing, because they rarely have assets for collateral and require additional support to become truly investment ready.

One solution for offering greater access to early-stage capital is the use of co-investing. This comes about when different types of social investors (i.e. public agencies, corporations, foundations, financial institutions, intermediaries, impact investors) pool their resources and create tailored financial packages comprised of different instruments (i.e. grants, loans, guarantees, equity) that are needed by the enterprise to operate and grow the business. The use of co-investing is a powerful way to unlock capital for the early-stage social enterprise market, leading to higher social impact.

However, the practice of co-investing in CEE is quite new, and most of the deals that have happened to date have been done through trial and error. As a result, there are not many models to build from or literature on the topic.

NESsT’s own experience with co-investment emerged from the need to leverage additional capital for the early-stage enterprises in its portfolio. NESsT defines early-stage enterprises as those that are up to four years into their development and show potential to be financially self-sustainable and scalable. These enterprises are not yet ready for market investments. Rather, they rely on patient capital – both impact investment and philanthropic capital (i.e. grants, recoverable grants, soft loans, guarantees, convertible instruments) – and ongoing and tailored capacity support to get to the next phase of growth. NESsT invests such financial instruments in tailored packages.

Although NESsT’s ultimate goal is to create a network of co-investors that could systematically come together around deals, to date these efforts demonstrate that developing the necessary relationships and packages is not easy. Many factors need to be aligned for co-investors to develop a strong partnership and be efficient in deal negotiations and deal making: What is each investor willing to support? How much funding is each willing to contribute? What are the return expectations? What is the time period for the investment, the exit strategy, and the post-investment involvement? Such

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1 2016 Annual Impact Investor Survey
alignment is rare, success stories are scarce, and frustration can often build up. NESsT has experienced such alignment in its partnership with Kiva, a U.S.-based lending platform that provides loans around the world (see page 6).

Investors must demonstrate a long-term commitment to making co-investment partnerships successful. They need to be willing to allocate resources and take risks to experiment. They have to work towards removing some of the existing internal barriers that may be preventing them from co-investing. They must recognize each player’s role and value in the ecosystem. In many cases, co-investors find that they spend a lot of time getting to know each other and negotiating terms. Sometimes, market realities such as types of capital available and return expectations may prevent investors from delivering on their original commitments. NESsT and Portus Buda Group (PBG) had this experience while trying to provide funding for social enterprises in Hungary (see page 7). The fragmentation of the sector and the limited number of early-stage investors exacerbate the challenge co-investors face in developing partnerships.

Often, the only alternative is to use a deal-by-deal approach in developing co-investment packages, as NESsT did with its support of Inka Moss, a high-impact Peruvian social enterprise (see page 3). This approach is far from ideal, as it can delay the growth and impact of the social enterprise, since the timeline for securing funding can be lengthy.

Despite these challenges, NESsT has identified a series of benefits that come from co-investing, and is convinced that more of it needs to happen in a planned fashion so that it becomes more effective. These benefits include:

- Pooling resources together leads to more significant deal sizes.
- Support from 2-3 co-investors can lead to higher quality investments and higher success rates for social enterprises.
- Investors are able to share knowledge and best practices with each other and the social enterprises.
- Communication efforts can be amplified by all partners, which increases visibility for the impact investing industry and contributes to its further development.
- If done efficiently, co-investing can reduce the costs associated with due diligence and overall financial management.
- Sharing risks among co-investors can lead to a higher willingness to experiment with innovative financing.
- Through co-investing, more types of financial instruments and packages will be tested and ultimately mainstreamed for the industry.

For all of this to happen, the industry needs to share its experience with co-investing to date. This case study does just that. It explores three examples of NESsT-led early stage co-investment partnerships, how they came about, the success factors that made them work, as well as the barriers they confronted. This case study shares key learnings from NESsT’s experience in developing co-investor partnerships, and lays the groundwork for how the industry can work together to facilitate more efficient and effective co-investing. Only by working together can donors and social investors leverage resources and maximize the social impact they are seeking.
Three Co-Investment Experiences

NESsT invests EUR 150,000-200,000 in carefully selected early-stage social enterprises. It provides grants, recoverable grants and soft loans (and sometimes loan guarantees), over the course of three years – the average time spent by a social enterprise in its portfolio.

In establishing its co-investment initiative, NESsT set a goal to provide up to 70% of the financing needs for each social enterprise and to raise the remaining 30% from co-investors (i.e. foundations and other philanthropic funding sources, social investors, public bodies).

When engaging with other social investors, NESsT gauges their interest in co-investing and whether the conditions for co-investment align. These conditions include:

1. Types of financing
   - Instruments: recoverable loans, debt, quasi-equity, etc.
   - Amounts
   - Return expectations (social and financial)
   - Time horizon of investments and repayment terms
2. Types of social enterprises (specific industries, impact areas, business models) and preferred stages of investment.
3. Geography
4. Due diligence process:
   - Documentation required
   - Duration
   - Decision-making
5. Level of involvement in the post-investment stage and other non-financial services provided
6. Expectations from investors in term of exclusivity, preferential terms, or even branding.

To date NESsT has collaborated with co-investors in two main ways: (1) deal-by-deal sourcing, which has proved to be more time consuming and resulted in higher transaction costs, and (2) a committed partnership with an aligned co-investor, the preferred way since it allows for more efficient disbursement of capital. These two approaches are reflected in the three cases.

DEAL BY DEAL:
INKA MOSS AND ROOTS OF IMPACT

Inka Moss is a Peruvian social enterprise that collects and processes sphagnum moss, a natural product that is highly demanded by international orchid growers. The company trains small farmers to collect the moss from their lands in a sustainable manner, and then buys it from them for a fair price, thus generating work for very low-income families in the Andean highlands. It also provides its suppliers with technology, materials and tools needed to collect and transport the moss, as well as infrastructure development in their communities.
Inka Moss joined the NESsT portfolio in 2014. Since then, NESsT has facilitated close to USD 380,000 in investments for the enterprise, directly investing USD 130,000 and raising another USD 249,000 from co-investors:

- A USD 8,000 grant early on from NESsT to prototype and test solar moss drying and processing press technology, to improve its collection processes and validate its business model.
- A USD 122,500 tailored hybrid financing package for working capital from NESsT, including (1) a loan sourced by NESsT from its partner Kiva (see page 5 for more information) for USD 50,000 (terms: 4%, three years, one-year grace period) for infrastructure and equipment needed to expand production capacity; (2) a USD 45,000 recoverable grant, to be repaid over five years (following a two-year grace period) to grow sales in new markets in the United States and Asia; and (3) a USD 27,500 grant directly invested in the local, remote communities for tools, ropes and mules.
- A USD 190,000 grant from a UK corporate foundation to expand the enterprise into 13 new communities.
- A USD 59,000 loan provided by an international foundation for further production capacity expansion and plans.

As the enterprise needed to expand to new communities in order to increase its social impact, NESsT supported its management team with attracting new funding via a pay-for-success program from Roots of Impact in Germany. The repayment structure is contingent on future performance and impact metrics related to a higher number of harvesters and greater earnings for them. The total amount to be mobilized under this scheme is USD 600,000 (debt or equity) over four years, with a total maximum amount of performance-based payments of USD 240,000.
Success Factors

- Alignment between the entrepreneur and the co-investors around the social and environmental impact of the business.
- Cooperation between intermediaries and investors at different development stages of the social enterprise (i.e. start-up, validation, growth), ensuring steady growth and increasing investment readiness.
- Co-investors’ funding and non-financial support complemented each other in order to fill in the enterprise’s financial and strategic gaps. All parties brought their own specific value to the table. Besides funding, the expertise of each co-investor interacted in a useful way with each other.
- A skilled leadership team and a strong governance structure in the enterprise, allowing for strategic decision making, a clear growth vision and solid implementation skills.
- Transparency and accountability among all the organisations involved.
- Wise use of networks, pro bono support and a wide range of ecosystem players (i.e. universities, local and national governments, community organisations, social investors) to strengthen the business model and make it investment ready.

Gaps/Challenges

- Difficulty to align all co-investors and entrepreneur’s timelines and priorities.
- Integration of the various post-investment support and reporting requirements from co-investors can be challenging for the management team of the enterprise. Need to be careful not to overload the entrepreneurs.
- Structuring co-investment agreements is complex, especially when investors have different instruments (i.e. equity, grants, debt, pay by results), ownership structures (i.e. public vs private) and return expectations. For example, the first investor in a social enterprise may provide non-investment services such as grants or technical assistance that are not included in the valuation of future financing rounds. This may limit the upside for the first investor while boosting returns for follow-on investors, thus shifting incentives towards later rounds.
- Need for co-investors to take responsibility for conducting certain aspects of their own due diligence to validate that the investments align with their objectives, risk and return profiles.
STRUCTURED PARTNERSHIP: KIVA

In 2015, NESsT teamed up with Kiva, a nonprofit social lending platform, to provide debt capital to portfolio social enterprises. The two organisations complement each other’s work, as the loans leveraged through Kiva must serve the needs of poor, vulnerable, and/or excluded populations, or aim to achieve high social or environmental impact.

Kiva vetted NESsT as a quality field partner and provided a credit line with the flexibility to design loan products that match the needs and cash flow realities of its portfolio. The loans raised through Kiva individual lenders range from USD 2,500 to USD 50,000, with repayment schedules (generally between six months and 10 years) designed in any configuration to best meet the needs of the borrower (i.e. weekly, monthly, annually, as a bullet payment at the end of the term, or irregularly). The interest rates range from 0% to 8% depending on NESsT’s cost of providing the loans.

Thanks to the partnership, NESsT is able to connect individual lenders on the Kiva platform to social enterprises around the world. To date, seven loans totalling USD 230,000 have been funded with contributions from 6,547 individuals, and the loans are being repaid on time by the social enterprises.

Success Factors

- Alignment between the two organisations that created the partnership: same vision (lift people out of poverty) and complementary activities.
- Partnership fits a need for both organizations: Kiva needs pipeline to pitch to its growing membership of online lenders; NESsT needs capital to deploy to its growing social enterprises.
- Understanding of early-stage social enterprise funding needs and willingness to innovate and take risks. Kiva provides capital at 0% interest, which has allowed NESsT to develop more accessible loan products that other funders may be unwilling to finance.
Sustainable business model for the program: NESsT, as a field partner, may charge its borrowers a reasonable interest rate or fee if necessary to operate the lending program.

Strong cooperative relationship developed between the staff members of the two organisations with clear roles and responsibilities established at the beginning of the partnership and agreed upon in a memorandum of understanding.

Flexibility in loan sizes and terms, ending up with products that meet the individual needs of each enterprise and their repayment capacity. It has led to a 100% repayment rate to date.

Long-term track record and global reach of both organisations contributed to credibility, trust and exposure for the loans on the platform.

Gaps/Challenges

- Limits on the amount that can be raised on the Kiva platform, typically a maximum of USD 50,000, with Kiva lenders preferring shorter-term loans.
- Need to cover NESsT’s costs for operating the program through donations (specifically for staff time to post and promote borrower information on the Kiva platform, to collect and remit repayments, to maintain necessary IT and CRM systems, and to cover currency exchange losses).
- Timing the posting of new loans to match Kiva users’ lending behaviour on the platform, in order to increase the chances of each loan to be raised.
- Promotion of the loan to ensure the full amount is raised before it expires from the platform after 30 days. If the full amount is not raised, the field partner does not receive any funds.

Structured Partnership: Portus Buda Group

NESsT and Portus Buda Group (PBG), the first impact fund to be created in Hungary, partnered to accelerate the development of a co-investment program in Central and Eastern Europe. The goal was to share due diligence and pipeline, to pool resources and thus increase capital flows for social enterprises.

The two organizations signed a memorandum of understanding formalizing their commitment to do joint due diligence and making social investments, agreeing to build on each other’s strengths: the PBG’s investment knowledge from managing a JEREMIE portfolio and NESsT’s experience with growing and supporting social enterprises, as well as impact metrics and measurement.

PBG’s plan was to launch the impact fund in the first quarter of 2017, with a first-closing of EUR 3.75 million (out of a total of EUR 20 million). The first investors in the fund were high net worth individuals from Hungary, motivated by strategic philanthropy and social impact, and the idea of recycling their money at a low return (1.5%). Initial investments would happen in Hungary, but cross border co-investments were also planned for the coming years. PBG also contemplated co-investing and sharing pipeline with other social investors from the region. PBG’s initial plans were to make 3-4 deals per year, mainly as unsecured loans, at a minimum of EUR 100,000 for four to eight years with a 5% annual interest rate. While PBG was still in the process of fundraising for its first-close, PBG and NESsT started assessing three potential investees from its portfolio from Hungary: Kek Madar, Matyodesign and Alko-Soft.
NESsT and PBG collaborated closely during the process, sharing their experience in the ecosystem and due diligence materials for selected social enterprises. NESsT and PBG staff members had numerous meetings, with both teams highly motivated by the desire to invest in high-impact social enterprises. The selection criteria for PBG’s fund which aligned closely with NESsT’s own expectations, included: (1) strong and measurable societal impact, (2) entrepreneurial and effective team, (3) validated, sustainable and scalable business model with information on the industry and competitive analysis, and (4) a clear exit strategy.

However, as PBG’s fundraising process advanced, the fund attracted institutional investors that, while they could invest larger ticked sizes, also targeted higher financial returns. This changed the final outlook of the fund, which increased its deal size and return expectations that no longer fit the profile of NESsT’s portfolio and early-stage social enterprises more generally. PBG and NESsT decided to transition their partnership toward a loose collaboration around promoting the ecosystem for impact investing rather than direct co-investing in social enterprises.

### Success Factors
- Complementary roles in the ecosystem: NESsT as a pipeline developer, first round social investor and non-financial services provider; PBG as a social investor willing to co-invest.
- Similar vision in term of financial products needed by social enterprises: (1) structure – patient loans, flexible repayment terms, (2) individualized financial packages and usage - purchase of equipment, working capital, expansion of activity and bridge financing to cover temporary cash flow difficulties.
- Similar due diligence and decision-making processes, as well as post-investment involvement.

### Gaps/Challenges
- Institutional investors’ appetite for larger deals and commercial returns, and the lack of products to invest in early-stage funds.
- Legal constraints from one of the major investors in the PBG fund to invest outside Hungary, which limited deal flow.
- Iteration of PBG’s fund mission toward later-stage deals to align with the existing pools of capital available in the marketplace.
- Challenges of raising philanthropic capital to pay for market building efforts – few donors and social investors are willing to fund pipeline development.
Lessons Learned

- Ensure alignment in purpose and social impact thesis, vision and investment beliefs, investment criteria, due diligence process, and willingness to mitigate risk (i.e., understand each other’s role in the market and ecosystem and leverage each other).
- Take time to get to know each other and build trust. Good relationships are the basis for good deals. Therefore, each investor needs to understand the other’s motivations (i.e. impact, return, market building opportunity, reputation gains, personal relationship with the entrepreneur), track record, and value they can bring.
- Recognize that structuring a co-investment agreement takes time and commitment. There are many elements to negotiate, especially around coordination, transaction costs, risk sharing across co-investors, return expectations, and post-investment involvement, especially when there are more than two co-investors involved.
- Securing resources for the deal preparation and co-investment negotiation stage, for the deployment of capital and for the post-investment support is essential for all partners. For instance, NESsT’s lack of untied capital to explore and be able to take more risks contributed to some of the inefficiencies in past co-investments. Sufficient and flexible funding would accelerate processes.
- Be open to sharing information, experience, and best practices among investors and with the sector to help build the industry.
- Approach each deal as a long-term partnership between the co-investors and the entrepreneurs, and be prepared to work as a team.
- Coordinate early in the process. By collaborating on the due diligence and coordinating timelines of potential deals, co-investors can minimize the burden on the entrepreneur.
- Bring specialized national expertise (i.e. taxation, legal, regulatory) to each deal, even if it increases transaction costs.
Recommendations

The reality of the market, the level of development of the industry, and the above presented cases show that mixed funding packages disbursed over several years and connected with investees’ performance make sense. The long-term support of a social enterprise in its growth journey requires several types of supporters and investors. Therefore, social investors need to work together throughout the life cycle of an enterprise and complement each other, not only by leveraging each other’s resources, but also by being willing to experiment with different instruments and explore new ways to invest.

In order to accelerate such processes, some actions need to be in place:

- Recognize the role of intermediaries who match the demand and the supply for capital. They work with both social enterprises on their investment readiness and social investors, fostering alignment, encouraging them to take risks. They play a facilitation role in negotiations, help with due diligence and bring together different types of investors.
- Facilitate the grouping of social investors around impact areas and specific social problems (i.e. refugees, at-risk youth, environment, etc.) to streamline alignment of objectives.
- Grow movements around social investment and promote co-investments. The Central & Eastern Europe Social Investment Task Force is such an initiative. It aims to catalyse the patient, early-stage social investing sector in the region. It fosters a community of like-minded investors, giving them the space to work together and to share information and expertise.
- Promote successful co-investment partnerships and share with the wider sector. Disseminate results and celebrate successes.
- Increase the role of public funding in unlocking the market by taking on a first-loss role in order to attract private capital.
- Create new risk assessment tools that allow mainstream investors to address the specific challenges of social enterprises, including their lack of collateral and social impact. Investors should recognize the value of financing and supporting investment-readiness stage, directly in social enterprises or through an intermediary.
- Engage philanthropic capital to develop and experiment with new instruments that respond to the long-term patient capital needs of social enterprises, such as recoverable grants, patient loans, and revenue-sharing schemes.
- Promote crowd-investing initiatives in Central &Eastern Europe, using Kiva and similar platforms in other regions as examples of initiatives to replicate.
- Create easy-to-access guarantee schemes for intermediaries to facilitate the use of loan instruments and allow social enterprises to access regular SME funding programs.
- Streamline legal and regulatory requirements, including fiscal incentives for social investors.
ABOUT NESsT

NESsT has been working for 20 years to provide dignified employment to lift people out of poverty in emerging markets. NESsT achieves its mission by raising philanthropic capital to invest in and develop social enterprises that create employment and viable income opportunities for the poorest communities facing isolation, discrimination, lack of job skills and poor education. To date, NESsT has invited 187 social enterprises to enter its portfolio providing them with an average of four years of support and investing more than USD 15 million in capacity building and direct funding. Though this investment, NESsT has contributed to creating more than 49,500 dignified employment and sustainable income opportunities.

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