PERFORMANCE ALIGNED REDEEMABLE CONVERTIBLE STOCK

Performance Aligned Redeemable Convertible Stock is an alternative to traditional debt or equity structures that is designed to match investor returns with company performance.

Impact investors who are considering equity investments face a common dilemma: The reality of the current market is that there are not enough equity exits. Therefore, social equity investors do not have a mechanism to realize equity-like returns commensurate with the risks inherent in early stage social businesses.

The default "next best idea" for financing social enterprises is debt. However there are often significant problems with debt, notably 1) lower returns for investors, 2) it is difficult to structure a predetermined amortization schedule that is flexible for the company - especially in the first few years of growth, and 3) creative structures can create tax problems for investors. (We expand on this last point in detail below).

To remedy this problem we designed the Performance Aligned structure to meet these investor goals:

- provides equity-like returns to investors, both in IRR and risk
- provides investors an exit in the form of near to mid-term return of capital so investors can redeploy capital to other social investments
- is flexible and minimally burdensome to issuing companies
- is tax efficient to the investor and issuer

HOW PERFORMANCE ALIGNED STOCK WORKS

When a company issues Performance Aligned shares the company is committing to used a fixed percentage of its revenues to return capital to the investor via a preset ratio of dividends and share redemptions.

At the end of each quarter the company

1. Calculates the Dividend and Redemption Pool (D&R Pool) - typically 2-8% of cash basis revenue.
2. Uses the Dividend Portion of the D&R Pool to pay a dividend to all remaining shareholders
3. Uses the Redemption Portion of the Return Pool to redeem shares.

The Dividend and Redemption Portions are preset ratios. Combined they return a set maximum dollar return to the investors by the time all the securities are redeemed. For example, if the investors are to receive a 300% return by the time all the shares are redeemed, they would set the Dividend Portion at ⅔ and the Redemption Portion at ⅓. (Note: IRR will be less than the Target Cash Return due to time value of money)

Target Total Cash Return is mathematically related to the redemption ratio. The REDEMPTION Portion = 100% / Target Total Cash Return%. The Dividend Portion = 1 - (REDEMPTION Portion)

Target Total Cash Return	REDEMPTION	Dividend
150%	67%	33%
200%	50%	50%
300%	33%	67%

The terms should be structured so that for the agreed revenue projections the investor will have all of their shares redeemed within 5-8 years, meeting the investor's target IRR.

The investor is still taking an equity-like risk because in the event the company revenues grow slower than forecast, the investor's IRR declines due to the slower pace of redemptions. However, the investors can convert their unredeemed preferred shares to common shares at any time.

ACCOUNTING/TAX TREATMENT

Investors who purchase Performance Aligned shares issued by a corporation should be able to treat each redemption as a combination of a return of basis and a dividend. If the issuer has retained earnings greater than the redemption, then par value of the stock is treated as return of basis and the premium is treated as a dividend. If the issuer does not have sufficient retained earnings (which could happen in the early years in some startups) then the par value and redemption premium are both treated as a return of basis.

Even though the security is a preferred stock, the issuer will need to follow FASB 150 "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity". This rule requires the issuer to record the security as a liability on their balance sheet.

WHY IS THIS A PREFERRED STOCK INSTEAD OF DEBT?

It is possible to structure a debt offering where the payment schedule is based on a percentage of revenues. Unfortunately there is a major problem with using that structure because under US tax law, that structure would need to use the Noncontingent Bond Method of accounting. This accounting treatment requires investors to accrue OID interest and thus pay taxes on the accrued interest. In the early years of such a note, US investors would be paying taxes on interest that they would not actually receive for several more years.   Equity structures can be subject to OID but the IRS rule under 305(c) that would establish OID for equity have trigger conditions that are not part of the Performance Aligned structure.

CONVERTIBILITY

We recommend that Performance Aligned shares be convertible into common stock at any time. This is a valuable feature to the investors and, when included, should reduce the Return Pool portion of the cost of capital .

Many investors looking at debt instruments seek warrants or some way to participate when the company exceeds expectations. We hear statements from investors like: “I don't like equity because I have no exit so I prefer debt, but I don't want to excluded from equity returns if the company does really well.”

Putting all or most of the higher target equity return into a debt structure is not necessary if the investor can still retain equity returns. For example, consider Performance Aligned Prefered that is structured to return 15% IRR to the investor. The equity valuation is set higher than the investors believe is correct given the early stage of the company so the investor is expecting their return to come from the Return Pool. They expect that over 4-6 years they will exit the investment completely from the share redemptions. However, by third year the company has become much more successful and now the equity valuation is higher than the the valuation implied in the conversion. The investor has the choice to either convert to equity - or keep receiving the Return Pool knowing their investment will exceed their target IRR and their capital will be returned faster than they expected (because the Return Pool is funding redemptions faster).

EXAMPLE PERFORMANCE ALIGNED PREFERRED STRUCTURE

Newco and its investors have agreed on the following revenue projections;

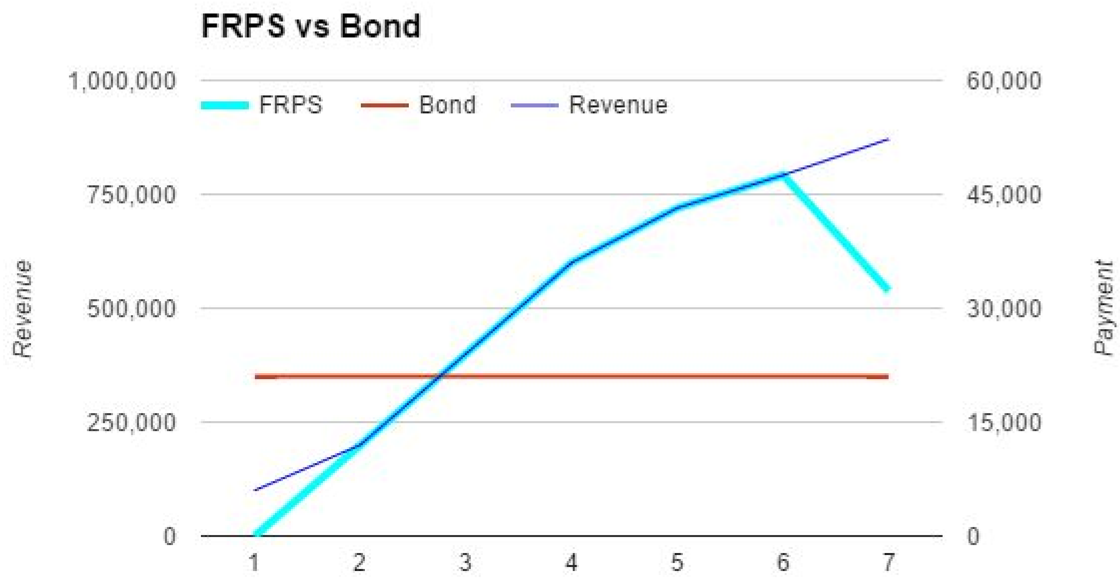
Year	1	2	3	4	5	6	7
Revenue	100,000	200,000	300,000	450,000	540,000	594,000	653,400
Growth		100%	50%	50%	20%	10%	10%

Newco is issuing $50,000 of Performance Aligned Stock that, starting in year to uses 6% of cash revenue to redeem the Performance Aligned shares at 300% of par. Newco's margins are high enough that its ability to grow is not handicapped by the 6% dedicated for the Performance Aligned Preferred. Par is $100 so each redemption will be $100 return of basis plus $200 dividend (assuming sufficient retained earnings). This results in the following redemption structure.

Year	1	2	3	4	5	6	7
Revenue	100,000	200,000	300,000	450,000	540,000	594,000	653,400
Growth		100%	50%	50%	20%	10%	10%
Basis Return	0	4,000	6,000	9,000	10,800	11,880	8,320
Dividend	0	8,000	12,000	18,000	21,600	23,760	16,640
Total	0	12,000	18,000	27,000	32,400	35,640	24,960

The IRR of this investment under this revenue scenario is 26.5% with all their stock redeemed by the end of year 7, with all invested capital returned by the 4th year.

Had the issuer offered a bond with the same target IRR instead of a Performance Aligned - the following chart shows the payment differences. Note the lower Performance Aligned payment in the early years which are the years the company should be deploying capital for growth. (Lowering the target IRR to make it "more bond like" reduces total company costs but still has the problem of high/inflexible early years payments and mismatched risk/return for the investor)



THE PERFORMANCE ALIGNED SOCIAL IMPACT

By aligning company performance with investors returns, the Performance Aligned structure also aligns financial returns with social impact. Successful social enterprises scale their impact with their growth. Many existing financial structures impede growth by misaligning repayment with performance.

Inappropriate investment structures also lead to tensions with investors because the structures do not flex with changing business conditions and/or create barriers to future rounds of investment. Impact investors do not benefit if the entrepreneur is motivated to make capital allocation decisions for any reason other than what is best for the impact and performance of the company.

The Performance Aligned structure can also be used to create an alternative to an employee stock plan for the beneficiaries of a social enterprise. For example, the jewelers at Relevée would not benefit from a traditional ESOP as there is no market where they could sell their shares. Therefore Relevée created a fund owned by the women, that like the Performance Aligned is funded by a percentage of revenues. This is the best solution for the women and further aligns the investment and impact returns.

STRUCTURING PERFORMANCE ALIGNED PREFERRED STOCK

We have created term sheets and a financial model to analyze with the structuring.   The key variables in the model are:

- Revenue forecasts
- Percentage of Revenues used for redemptions (typically 2-8%)
- Target Total Cash Return (typically 200-300%)

Those inputs produce a redemption schedule, the dividend and redemption ratios, and forecast IRR.

For early stage companies, forecasting revenues is highly uncertain and investors will rightly seek conservative revenue forecasts. The company and investors should remember that the target IRR and forecasts are interrelated. Where there is great uncertainty in forecasts such that the investor wants a high IRR, the investor should consider deferring to the company forecasts but then setting the Percentage of Revenues and REDEMPTION Premium to get the higher target IRR.

Companies should set the percentage of revenues used for redemption with care to ensure the number is not so high that it restricts growth or creates a barriers to future rounds of investment. A good general rule would be to set the percentage at about 10% of gross margin.

We recommend forecasting returns using a variety of alternative structures. For example, an investor that wants at minimum 5% return but hopes to be able to make in excess of 20% return could run scenarios using low revenue forecasts to calculate how far off the company projections can be and still make the 5%.

If the convertibility feature is included, the issuer should set the if converted common stock value higher than what the investor thinks is the current equity valuation of the company. The convertibility feature should be looked at as an option and how close the option is to being in the money will affect its value/cost.

The most contentious part of structuring conventional equity is agreeing on the pre and post money valuation. Investors using the Performance Aligned structure are investing with the expectation that they will not be long term equity holders as they expect their shares to be redeemed. Therefore the company can stipulate an equity valuation that is higher than they could with traditional equity. This could be a benefit when structuring followup equity rounds as it establishes an round A valuation, but care must be taken to make sure the valuation does not create a barrier to future equity rounds. The the proper balance is too difficult to strike or if the investor does not value the option, the convertibility feature can be removed or discounted.

ALTERNATIVE STRUCTURES

The best structure for Performance Aligned is to fund redemptions from a percentage of Cash Basis Revenues. This directly links the repayment to performance and is simple to define and audit. However, it is possible, but not generally advisable, to use the same structure but replace revenue with some other calculation of cash flow like Gross Margin. In such a case we recommend a very strict definition of gross margin, for example, Gross Margin = Cash Revenues minus Cost of Goods Sold. Even such a simple definition does create issues that are avoided by using Cash Basis Revenues .

We caution against using any alternative to Cash Revenue that is ambiguous or that could create disincentives for the company. For example, avoid structures using Operating Cash Flow as these structures create tension between investors and the company over what is or is not an operating expense. Even in the absence of tension, such a structure interferes with how the entrepreneur makes their best judgment on how they should utilize capital.

The Performance Aligned structure can be modified in many ways to match a company's business model. Non-standard structure examples include:

- Longer grace period for companies that will have lower margins in early years
- Replace fixed percentage to Revenue Pool with a changing schedule - for example year 2 could be 2% of revenues growing to 8% in year 5. This could also be modified to set the percentage of revenues based on top line or margin targets.
- Replacing fixed dividend/redemption ratios with a changing schedule of ratios -for example year one could be 10% redemption but year 3 is 50% redemption.
- There could be a fixed redemption term after which if all the shares are not redeemed the securities convert to common.

WHO SHOULD/SHOULD NOT USE PERFORMANCE ALIGNED PREFERRED STOCK

Performance Aligned is suitable for startup or early stage social enterprises seeking equity-like investment. For example, this structure would be well suited for a new enterprise who is in an early proof of concept or selling phase with a reasonable projected adoption and growth phase - especially if they are uncertain about the timing of the growth phase and need the capital to get to accelerating growth.

Performance Aligned would also suit existing companies with strong revenues but other credit issues that prevent them from using debt, such as when the company is profitable, seeks to invest in achieving scale, and isn't making the cash surplus to fund the growth.

Performance Aligned can also be structured as a debt alternative to companies with highly seasonal business models. For example, consider a company that has a high percentage of sales concentrated in one quarter. This company is strongly cash flow positive for the year because of the one good quarter, but the other quarters have negative cash flows. For this company, the shares could be structured to provide a lower “debt-like” cost of capital while providing the company greater operating flexibility.

When using a percentage of revenues for redemption, issuers should be careful to evaluate if their gross margins will grow to be high enough that the revenue percentage does not consume more cash flow then the company can afford. For example, consider a company in its early phase that plans on having high customer acquisition costs but margins will be low until they reach a certain volume of sales. A company like this would be hurting itself if the revenue percentage effectively consumed the net margin needed for customer acquisition. The company and investor would need to make sure that they either raise enough capital with the structure to last until margin growth, or they should consider an alternative implementation like using Gross Margin to fund redemptions.

Performance Aligned Preferred is not appropriate for financing seasonal working capital, trade finance, or other similar needs that are better suited by debt.

HISTORY OF PERFORMANCE ALIGNED PREFERRED STOCK

During the last three years, 1to4, ADAP, and BOMA have developed and are invested in over twenty companies using revenue-based repayment models. These meet the financial objectives stated above for Performance Aligned Preferred. Social entrepreneur John Berger, who is also a Chartered Financial Analyst and spent two decades as an investment banker, undertook the objective of clarifying tax treatment of the revenue repayments and of minimizing potential IRS issues. John worked with pro bono outside legal counsel to assess different approaches. The clearest and fairest approach for all parties turned out to be the Performance Aligned Preferred Stock. John is COO and co-founder of Relevee, a startup international fine jewelry brand with high margins and high social impact. He intends to use the Performance Aligned model for his current investment raise.

ABOUT BOMA INVESTMENTS

Boma Investments LLC works with early stage social and environmental for-profit businesses, working side by side with entrepreneurs. We provide advice on topics such as financing and organizational development; contacts to investors and mentors; and early stage financing. While BOMA has founded several companies, most of its work is as a minority shareholder and/or lender. We work all over the world, with partner companies and target countries with developing economies. Typically, the entrepreneurs we work with have a viable product or service, have proven that the concept works, and want to bring it to the next stage. Boma’s co-founders Ron and Marlys Boehm are very aligned with the entrepreneurs, particularly those who are passionately committed to keeping their social mission alive.

ABOUT ADAP (A DIFFERENT APPROACH TO POVERTY)

ADAP invests in early-stage social businesses that are working to eradicate extreme poverty. ADAP has a solutions-based investment approach seeking to have long-term social impact by applying two guiding principles:

- Utilizing the power of the market: We invest in innovative, market-based businesses that have the potential to scale utilizing strategic financing.
- Unleashing the power of dignity: We seek dignity for all stakeholders, while ensuring that all voices are represented, are heard and feel heard, with win-win-win scenarios for all stakeholders (investors, entrepreneurs, and in-country stakeholders.)

ABOUT 1TO4

At 1to4, we use a suite of innovative products such as our Guarantor programme and our GiftVest programme to provide solutions which :

- Recognise the value of microfinance to foster financial independence for the most vulnerable populations.
- Recognise that talented individuals often outgrow what microfinance can offer and desperately need access to small business finance.
- Small businesses create jobs. Sustainably. Everywhere.
- Small businesses invest, pay taxes and contribute to a country's long-term well-being.
- Recognise that the microfinance and small business finance sectors need to grow and can be significantly enhanced by investments in capacity building technologies and products.

About Womble Carlyle Sandridge & Rice

The Performance Aligned Preferred Stock structure described in this white paper was developed in collaboration with members of the Impact Team at Womble Carlyle Sandridge & Rice, LLP, a full-service business law firm with 14 offices that serves a wide range of regional, national and international clients across many industries. Womble's Impact Team is committed to fostering the growth of the Impact Economy by championing Impact-focused businesses and investors, as well as working to develop innovative financial products and legal structures that help power commerce in the Impact Economy. For more information please go to www.wcsr.com or contact Pam Rothenberg (prothenberg@wcsr.com) or Mark Newberg (mnewberg@wcsr.com).

ABOUT THE AUTHOR

John Berger is the co-Founder and COO of Relevée a women owned fine jewelry design and manufacturing company.

John is a Chartered Financial Analyst with 18 years of investment banking experience and has extensive experience evaluating, improving, and financing business models and marketing strategies in a variety of industries.

John learned about the desire for this type of new structure at the 2015 Opportunity Collaboration where he was seeking investors for Relevée. He created the Performance Aligned structure in consultation with outside counsel and investors 1to4, ADAP, and BOMA Investments.

Relevée provides a pathway to complete independence for some of the world's most vulnerable women including survivors of human trafficking, domestic violence and child marriage. Relevée was started by, and is spinning off from the non profit social enterprise Made By Survivors.

Relevée is majority woman owned with innovative participation structure for the women jewelers. Our team of jewelers participate in the company's performance in parallel with the Performance Aligned investors as we dedicate a percentage of revenues to a fund owned by the women

References

This document is version 3 of the White Paper (January 21 2016). When we release updated versions and supporting documents they will be available at:

https://drive.google.com/folderview?id=0B6PdsJm_mK13MDFrUUp2NGNMc1E&usp=sharing

- Issuer's accounting treatment found in FAS 150
    - http://www.fasb.org/pdf/fas150.pdf
- IRS rules related to sources of dividends and tax treatment
    - 26 CFR 1.316-2 https://www.law.cornell.edu/cfr/text/26/1.316-2
- IRS letter ruling on mandatory redemption preferred treated as equity
    - PLR 201025045
    - http://m.klgates.com/irs-issues-private-letter-ruling-on-debtequity-treatment-under-liberalized-ruling-procedures-07-07-2010/
- Why you don't want to use debt - subject to OID
    - https://www.law.cornell.edu/cfr/text/26/1.1275-4
- Why prefered stock redemption premiums are subject to OID
    - https://www.law.cornell.edu/uscode/text/26/305