

DUE DILIGENCE NOTE: Balancing perspectives to keep the mission intact

I. Introduction

This note is intended to be a guide for social entrepreneurs and impact investors around nurturing an atmosphere of mutual trust and understanding during the due diligence phase when raising investments. This is one of the most crucial aspects of an enterprise's journey and growth, as the terms at which one has brought in investors to his/her venture will surely shape the enterprises' future. Investors bring significant experience and technical expertise into an organization apart from funds. Hence, being able to identify and bring on board aligned investors should be a process taken with care so that at the end of the day the social mission of the enterprise intact irrespective of changing actors.

This document has attempted to bring in a practitioner's perspective building on SELCO and its incubatees' investment experience but with an emphasis on these three aspects:

- Perspectives built on experience and observations around setting a healthy atmosphere during discussions that promotes trust and transparency.
- A generic checklist of items that is commonly required for any investor-led due diligence also forms a part of this document.
- Suggestions for mission protective clauses in term sheets. In doing so, a few crucial questions that were asked to entrepreneurs and investors alike include: *What are the clauses that most affect future enterprise operations in term sheet? Clauses that are most discussed during term sheet negotiations? Which are the clauses in the term sheet included by investors and/or enterprises to keep the social mission intact? By asking such questions, some of the sticky term sheet clauses were isolated for further study and clarity. The term sheet clauses discussed in this document is not exhaustive, but were viewed as critical to ensure that the mission of the organization remains intact irrespective of changing investors or ownership.*

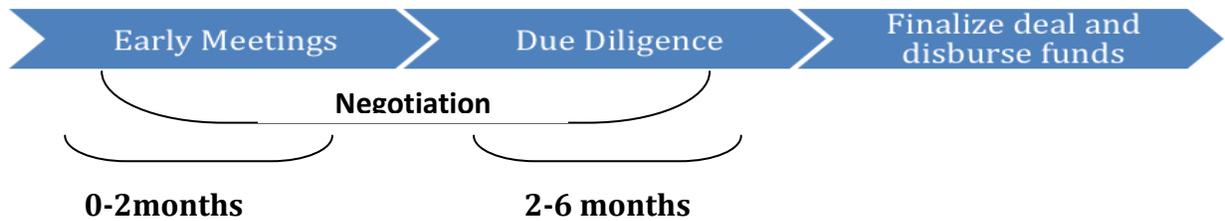
These aspects were chosen based on preliminary findings that these aspects were not to be fully explored. By no means do we have all the answers nor are we attempting to repackage existing work. We encourage you to use this as one of the guiding resources but also browse complementary sources. Some of them have been included at the end which resonated with our own experience.

II. The Negotiation Process

The negotiation process covers early familiarization among potential partners before the due diligence process. The latter is more well understood to constitute a series of fact-finding and business risk assessment activities carried out by the investor directly or a front-end organization who represents the investors interests. This is agreed to be necessary in order to reduce the information asymmetry gap and give the investor a clearer understanding of the business idea or plan that underpins the proposal. It has both qualitative and quantitative dimensions typically covering financial, operational, legal and external environmental factors that affect and potentially influences the field in which the enterprise operates.

Typically, the negotiation process begins from the submission of investment memo/proposal from the entrepreneur's side. The entire investment process may take between 6-18 months and the due diligence activity may itself comprise of 6-8 months of investment fact-finding by the investor, before a term sheet is exchanged with

the entrepreneur. The entire investment process is adapted from routine commercial business processes as given that a social enterprise follows the principles of business to achieve its social mission.



Timeline: From negotiation to due diligence to deal finalization. SELCO experience

While it is widely acknowledged that there are different types of investors and lenders¹ looking for widely differing types and quantum of returns, for the purpose of this document the scope is limited to an impact investor who in addition to moderate financial returns gives equal if not more weight to social returns i.e. impact that benefits underserved societies.

Importance of the Negotiation Process

- **Business idea vs business plan:** a plan sets in place concrete steps towards your goals but more importantly is the core idea around which the entire organization has been set up. It is important to find investors who share your passion for the business idea using the business plan as a reference tool. Enterprises in developing countries suffer from a weak support system which further stagnates growth. There are forces coming together to build this ecosystem but in the interim entrepreneurs need to be honest about these challenges and find investors who are not only willing to invest despite these challenges but also be patient with you to build that supportive system.
- **Two sides of a coin:** The negotiation process is not just about the investor determining if you are a suitable candidate but also your opportunity to gauge whether you share a mutual vision and commitment to its fulfillment through ups and downs.
- **Constructive feedback:** benefits entrepreneur in getting together documentation and putting in place an information map or even processes at the prospect of a 3rd party review.

There are two key underlying strategies that have been deemed to be successful in setting appropriate tones for the discussion and laying a solid foundation for future discussions:

Team Composition

At different points in the negotiation process one will encounter questions related to philosophy, finance, future plans, and legalities and so on of the organization. Typically one person may not be able to answer on all these fronts. Rather, depending on skill set it is important to bring in appropriate representatives at different points in the due diligence process. For instance, at the onset when describing the philosophy, mission and future vision of the organization the founder is seen as a motivational puller. Subsequently questions around financial and operational sustainability are better handled by the COO and CFO or just the COO. However gut reactions, cross questioning maybe a strength of the COO and thus she/he might be useful to have in the first conversation. It also brings in a sense of confidence of the management at the helm of the organization and ability of the organization to sustain in the absence of the Founder's inputs. If paired with an investor representative who is similarly brought in with experience on the field, finance, operations it will significantly reduce the time needed to understand each other.

Partnerships over hierarchies

Very often the party with the funding is perceived to have the upper hand. The atmosphere can become hierarchical with investors leading the conversation and demanding information. Successful investments are typically rooted in

¹ A guidebook on preparing technology transfer projects for financing. UNFCCC (2006).
Due Diligence Note, May 2015

an understanding from both parties that this is a partnership with shared social missions. The enterprise is the vehicle to reach that goal and the funding is a crucial support to fuel it. One without the other is useless. The ultimate social mission is compromised or may never exist. Thus, both parties need to see themselves as being an equal partner in the discussions. Maintaining high levels of trust and transparency is vital to the process.

III. Other softer considerations include-

For Entrepreneurs:

Closing an investment is a huge milestone for many entrepreneurs because besides the resources to grow the enterprise it also brings together a group of external people who are committing to pushing forward your vision. Thus while it is perceived that the person who has the funds is entitled to do a complete investigation of a potential investee by the same token, the entrepreneur, also, is entitled to the reverse. A few thoughts-

- Investment philosophy-is it a match? Impact investors, particularly venture capitalists, have a short term outlook and seek investments with fast gains. Dig into ideas of scale vs innovations vs proven model to evaluate mutual agreements. Ask upfront questions particularly around failure, dealing with pressing issues and other challenges. This should be done in the early phase of discussion, 0-2months.
- Check with references of other investees/peers particularly around performance, ticket size, success rate, investments in similar segments (geography/sector/segment).
- Be attentive to the atmosphere around the negotiation process: Was the investor a good listener, were they responsive? Were they prepared about your organization for the meetings?
- Engage 3rd party investment advisors preferably peers or likeminded investors or incubators to assist in shaping your decision particularly around the long term-future of the company and the role of this investor.
- Finally, listen to your gut. Prioritize trust over valuation or monies. It will cost you.
- Investment process can be a long one so be prepared to invest significant time sometimes, even at the cost of running your business. Thus if the deal falls through one is better prepared for the time allocation spent on the deal.
- Patience. If the due diligence takes time it is for a good reason. Each Investor will have some requirement that is different from others mainly due to the structure of their funds. Be patient if you think the Investor is otherwise transparent and open in their need for such information. Figure out the way to speed up the processes. Self-check if you will invest money in your company if roles were reversed?
- Ask yourself if you are investment ready. In other words ensure you have completed all the statutory requirements in the company from the day it was formed. Also be sure to refer checklist and be prepared to save additional time.
- Be clear in your thinking when you wish to raise money. Do not change your position during negotiations unless there are compelling reasons beyond your control.
- Seek high quality professional help early in the deal. By and large this is not an area of expertise for the investee. Be prepared for the financial implications.

For Investors

For investors, a lot of the due diligence process is to reduce uncertainty. This is not a bad thing and makes sense if one is putting money on the table. However, very often due to haze of uncertainty - of the business, local conditions around stability in a short horizon, investors, tend to look sideways, to their peers, or to similar investments in developed countries to determine where and how to put their funds. The result are similar investments in similar enterprises. Thus investors need to come to the negotiation table with tools that will help take on the unfamiliar but with calculated risk.

- Build a connect with investee: Bring to the table folks who can identify with entrepreneurs or who are capable of building a connect with them. It will help in solidifying trust early on in the process and also assist

the investors in shaping their decisions. Most often investment firms are staffed with people who are not entrepreneurs or lived outside the investee area of operations thus making it difficult to establish a connect

- State clearly the non-negotiable points upfront. E.g. place on the Board, minimum holding of promoters in the company post investment, exit period.
- Explain the requirements' of your fund very early during the negotiations in as much details as possible
- Building capacity of front line organizations that represent the "faceless" investors who are most often in Europe or North America. They set the tone for discussions and trust early on so they should accurately represent expectations of other senior decision making representatives.
- Usually the potential Investee will have to deal with multiple people in the Investor's organization before signing the deal. It is important that one person from Investor's organization does the front ending with the Investee as much as possible. In case of handing over the deal to another department or another person (in cases where a person may exit Investor's organization) ensure that the pitch of the deal does not vary significantly with the other team/successor.
- Different vantage points: As mentioned earlier to reduce uncertainty it would help to have staffs that bring in perspective from different vantage points to help shape a decision and build an understanding of the unfamiliar. For instance having an entrepreneur on the advisory board.
- Be timely in response to decline the capacity to fund any organization especially in the early weeks of discussion. Do not keep the deal hanging even if your intentions may be good.
- Being clear about reasons for decline without ambiguous or harsh "no" is a good way to in a small way, help the organization improve or retool approaches if needed.
- Building in efficiency: Request for existing documents and only if necessary specific documents or perhaps a follow up call.
- A contribution vs funding. Moving beyond the role of one who gives funds and offering constructive advice to building the organization, a partnership, with the organization is important.
- Awareness of cultural communication and expectations: contexts outside The United States especially around ways of rejection.

IV. Term Sheets

Term sheet discussions follow the due diligence activity of the investors and once the business facts have been verified. The term sheet is non-binding and is perhaps the most crucial and thoroughly negotiated document during the investment process. The clauses in the term sheet will form a part of the shareholders agreement. It is important to realize that the clauses agreed upon during this stage will determine the course of engagement between the investor and the entrepreneur and ultimately guides the growth of the enterprise.

Since the scope of this document is to speak about the clauses and negotiation in the impact investment domain, mission protection is prioritized here more than singularly speaking from the investor or entrepreneur's perspective. The key considerations during the term sheet discussion that has to be kept in mind includes-

- *Investment Philosophy*: Entrepreneurs and investors alike must understand, match and reconcile their philosophy for the organization and investment before arriving at a decision
- *Partnership Approach*: Investors can have hands-on engagement as partners of the enterprise right from the negotiation phase, rather than the traditional hierarchical approach of remaining solely as funders
- *Ownership*: Shareholding should be structured in the best interest of protecting the company's mission. This can tilt from the entrepreneur to investor's side depending on the context
- *Clauses Vs Trust*: Term clauses have an expiration term and protection trigger. Entrepreneurs and investors alike must balance and appreciate the level of trust that forms part of successful investment partnerships

- *Time costs:* As the entire process may take a little over a year, entrepreneurs must account for the duration of the fund raising activity and potential delays while quoting investment requirements

Refer below Appendix 1. Suggested Mission protective clauses in the term sheet.

V. Checklist

Typically in preparation for the fundraising cycle, a list of documents is generally solicited. This list has been put together drawing from experience and a few other resources. It is differentiated into documents required to understand the business plan and documents to further understand inner organization workings. It can be found in Appendix 2. (attached excel file)

Resources:

1. ANDE Legal Working Group: Entrepreneur Introduction to term sheets [<http://tinyurl.com/nxbmkcm>]
2. UNFCCC Preparing Technology Transfer Projects for Financing [http://unfccc.int/resource/docs/publications/pract_guide_06_en.pdf]
3. Schwab Foundation Social Investor Manual [<http://www.weforum.org/pdf/schwabfound/SocialInvestmentManual2011.pdf>]
4. Toniic E-Guide Early Stage Global Impact Investing [<http://www.toniic.com/toniic-e-guide-fall2013/>]

Acknowledgement: We would like to thank our colleagues and mentors who took the time to give critical feedback over the course of this compilation- Phil La Rocco, Christine Eibs Singer, Ashis Sahu, Harish Hande, Revathi. K, Nagaraja Rao, Jeff Prins, Elena Casolari, Rustam Sengupta, Vinay Jaju.

Appendix 1. Term Sheet suggestions on mission protective language

Clause	Simplified Meaning	Suggested	Suggested term – Simplified
<p>Anti Dilution Protection.</p> <p>In the event that the Company issues additional securities in the future at a purchase price less than the previous round of fund raising, then this anti dilution clause provides protection to the investors in early rounds</p>	<p>If the next round of investment happens at a lesser valuation/price, then the investor either gets free shares or if the shares are not converted then there is adjustment in the conversion price.</p>	<p>If the price per security or share is lower than the prevailing investor price, then the bearers of investor shares shall have broad based weighted average anti-dilution rights. Such rights shall be exercised by way of an automatic adjustment to the investor conversion price, without the need for any further action of parties. The adjusted investor conversion price(ACP) is calculated as follows: $ACP = \frac{\text{Old Conversion Price} * (\text{Existing No of Shares} + [\text{Consideration to be received} / \text{Old Conversion Price}])}{\text{Existing No of Shares} + \text{Number of New shares to be issued}}$</p>	<p>If the earlier 1000 convertible shares were entitled to be converted @ say 320 Rs and the next issues of say 3400 shares are priced at say 290 Rs, then the adjusted conversion price will be calculated as follows:</p> <p>Old Conversion Price = 320 Existing No of Shares = 1000 Consideration to be received = $3400 * 290 = 986000$ New shares to be issued = 3400 Adjusted conversion price = $\frac{320 * (1000 + 986000 / 320)}{1000 + 3400} = 296.82$ Rs. Thus the conversion will happen @ 296 Rs and not @ Rs. 320</p>
<p>Right of first refusal.</p> <p>Right of first refusal with existing investors, in case the existing equity shareholder proposes to transfer their shares in the company to a third party.</p>	<p>If the existing investor decides to sell their stake in the company then the other existing shareholders should have the first right to buy the shares and only in the event if they are not willing to buy the shares, then the investor willing to sell his stake should look for a new buyer (other than the existing shareholder)</p>	<p>Right of first refusal with all existing investors, in case the existing equity shareholder proposes to transfer their shares in the company to a third party on pro rata basis.</p>	<p>If an existing investor who has a 25% stake in the company wishes to sell say 10000 Equity shares, then the other investors have the right to buy those Equity shares in proportion to their percentage of current holding of shares</p>
<p>Lock-in of Founder's & Investor's shares.</p> <p>The shareholders cannot in any way sell / transfer their respective shareholdings before the end of certain period from the date of Investments by Investors.</p>	<p>The purpose of this clause is to ensure that the founders remain invested and are sufficiently interested in managing the operations efficiently and effectively and the investors remain invested for sufficiently a long time</p>	<p>The invested shares are locked in for a period of 5 years, subject to a schedule of unlocking provided as provided below:</p> <p>1 Year – 15% 2 Years – 35% 3 Years – 55% 4 Years – 75% 5 Years – 100%</p>	
<p>Tag-along / take-me-along rights</p> <p>Subject to the lock-in provisions herein contained and to the extent the rights of first refusal are not exercised, in the event a Promoter proposes to transfer any Common Stock, the Investors would have a right to sell its shares on the same terms to the same party..</p>	<p>If the promoter or the majority shareholder sells his stake, the other investors/ minority shareholders have the right (not compulsory) to join the deal and sell their stake at the same terms and conditions.</p>	<p>The Tag Along Right shall be a pro-rata right and available to both the Founders/ Investors and other minority shareholders.</p>	<p>If an existing investor who has a 25% stake in the company has found a buyer to buy say 10000 Equity shares, then the other investors have the right to sell to the proposed buyer 7500 Equity shares (the balance 75%) in proportion to their percentage of current holding of shares</p>
<p>Drag-along rights.</p> <p>Holders of Preferred Stock and the Founders and all future holders of greater than certain percentage of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options) shall be required to enter into an agreement with the Investors that provides that such stockholders will vote their</p>	<p>Where one of the investors find a buyer, but the buyer wants to acquire the whole company or else is not interested in buying only the investor's share of the company, then this clause gives the right to the investor interested in selling his stake to drag along other investors and compel them to sell their stake as well to the interested buyer. This clause prevents a minority investor</p>	<p>No drag along rights.</p> <p>If a Shareholder (the "Offering Shareholder"), desires to sell any of the Equity Shares (the "Offered Shares") to any third party then the Offering Shareholder shall first offer (the "Offer") to sell the Equity Shares by sending a notice of the Offer (the "Notice") to the other Shareholders (the "Non-Offering Shareholders") with a copy to the Company, irrevocably offering to sell the</p>	<p>If an existing investor wishes to sell his stake in the company, he has to first offer to sell his shares to the existing investors. In the event if the existing investors are not interested to buy them within a stipulated time, then the Board can identify a buyer to buy the shares offered for sale on the same terms and conditions within a stipulated time. If the Board fails to find a buyer or does not exercise its</p>

<p>shares in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred and which is approved by the Board of Directors and the holders of certain percentage of the outstanding shares of Preferred Stock, on an as-converted basis</p>	<p>from blocking such sale.</p>	<p>Equity Shares to the Non-Offering Shareholders for cash. Within 15 (fifteen) days of the receipt of the Notice by the Offering Shareholder (the "Offer Period"), each Non-Offering Shareholder may at its option send a notice ("Transfer Acceptance Notice") in writing to the Offering Shareholder and the Company accepting the Offer in respect of all (and not less than all) of such Non-Offering Shareholder's pro rata portion of the Offered Shares (which pro rata portion shall be a percentage of the Offered Shares equal to the ratio of the Equity Shares then held by such Non-Offering Shareholder divided by the aggregate Equity Shares then held by all Non-Offering Shareholders. If all Non-Offering Shareholders issue a Transfer Acceptance Notice, then all such Non-Offering Shareholders shall be entitled and bound to purchase the Offered Shares in proportion to their pro rata portion thereof. If any but less than all of the Non-Offering Shareholders issues a Transfer Acceptance Notice during the Offer Period, then within (2) two days after the end of the Offer Period the Offering Shareholder shall send a supplemental notice to each such Non-Offering Shareholder that issued a Transfer Acceptance Notice and the Company, irrevocably offering to sell to such Non-Offering Shareholders their respective pro rata portion of the Offered Shares in respect of which the other Non-Offering Shareholders did not accept the offer to purchase Offered Shares within the Offer Period. Within (10) ten days of receipt of such supplemental notice to the accepting Non-Offering Shareholders, such Non-Offering Shareholders shall communicate amongst themselves regarding the remaining available Offered Shares and whether each desires to purchase its pro rata portion of the same, and each such Non-Offering Shareholder so desiring to purchase remaining available Offered Shares shall, within such (10) ten day-period, at its option send a supplemental Transfer Acceptance Notice in writing to the Offering Shareholder and the Company accepting the Offer in respect of all (and not less than all) of such Non-Offering Shareholder's pro rata portion of the remaining Offered Shares (which pro rata portion shall be a percentage of the</p>	<p>right to identify a buyer within a stipulated time, then the existing shareholder can sell his stake to a new buyer on the same terms and conditions set out originally while communicating his intention to sell his stake in the company. This clause also provides protection to the existing shareholders against selling the stake to a competitor.</p>
---	---------------------------------	---	---

		<p>remaining Offered Shares equal to the ratio of the Equity Shares then held by such Non-Offering Shareholder divided by the aggregate Equity Shares then held by all Non-Offering Shareholders electing to purchase a portion of such remaining Offered Shares). Any Non-Offering Shareholder issuing Transfer Acceptance Notice(s) as above shall pay the Offer Price in proportion to the Offered Shares proposed to be purchased by it, and accept a transfer of, all the Offered Shares or their respective entitlement thereof, as the case may be, and the Offering Shareholder shall be bound, on payment of the Offer Price to transfer all the Offer Shares or their respective entitlement thereof as the case may be, to the respective Non-Offering Shareholders. Such payment and transfer shall be completed within (15) fifteen days after the date of the last Transfer Acceptance Notice. If none of the Non-Offering Shareholders issues a Transfer Acceptance Notice and accepts the offer of the Offered Shares contained in the Notice within the Offer Period, or if, at the expiration of all relevant periods for delivery of Transfer Acceptance Notices, the Non-Offering Shareholders have issued Transfer Acceptance Notices and accepted the Offer to buy the Offered Shares in respect of less than all the Offered Shares, then, at the conclusion of such periods, the Board shall have thirty (30) days in which it may identify a third party purchaser (the "Board Identified Buyer") of its choosing to purchase all (but not less than all) of the remaining Offered Shares at the Offer Price and on the other terms and conditions set forth in the Notice. The Board shall exercise this right by delivering a written notice to the Offering Shareholder setting forth the name of the Board Identified Buyer and other relevant information. If the Board elects not to exercise the foregoing right, then the Offering Shareholder shall have the right to sell the Offered Shares not accepted by the Non-Offering Shareholders to the Proposed Buyer within 30 (thirty) days after the expiry of the Offer Period at the Offer Price and on such terms and conditions which are not more favourable than the terms in the Notice. If the sale and purchase of the Offered Shares to the Proposed Buyer (and/or Board Identified Buyer, as the case may be) is not</p>	
--	--	--	--

		<p>completed within the 120 (one hundred and twenty) days period following the expiration of the relevant periods described above, then the Offering Shareholder shall be subject to the provision of this Section as if no such offer was made.</p> <p>Notwithstanding anything in this agreement, the existing investors shall not Transfer their respective Investor Shares to a competitor of the company, except with the prior written approval of the Shareholders, determined based on their shareholding in the Company.</p>	
<p>Non-compete</p> <p>Each Founder and key employee will enter into a non-competition and non-solicitation agreement valid for a certain period of time in a form reasonably acceptable to the other existing Investors.</p>	<p>This clause prevents the founders and other key employees from creating a competing entity by leaving the organization or poaching its employees for a certain period of time</p>	<p>The promoters agrees that he shall not for a period of at least five years from the date of this agreement own, develop, manage, establish, engage in, operate or cause to be operated or consult in a business that competes with the business of the company. This also includes directly or indirectly, engage in the marketing or distribution of any services provided by the company or carry on the competitive business or solicit for the competitive business, and customer or target customer or key personnel or supplier of the company or otherwise use its knowledge or influence over any customer or target customer or key personnel or supplier to the detriment of the company. This, as an individual, employee, consultant, independent contractor, partner, shareholder, member or in association with any person except on behalf of the company,</p>	<p>This clause prohibits the promoters from starting a competing business upto 5 years from the date of the agreement.</p>
<p>Counsel and Expenses</p> <p>[Investor/Company] counsel to draft Closing documents. Company to pay all legal and administrative costs of the financing [at Closing], including reasonable fees (not to exceed \$[____]) and expenses of Investor counsel[, unless the transaction is not completed because the Investors withdraw their commitment without cause].</p> <p>Company Counsel: []</p> <p>Investor Counsel: []</p>	<p>This clause specifies who will be bearing the legal counsel costs of the investor and the Company.</p>	<p>Except as agreed to the contrary by the Parties in writing, each Party shall pay its own costs and expenses. All costs and expenses in relation to and for the consummation of the transaction including the expenses relating to issue of the Equity Shares, stamp duty on this Agreement and other charges payable in respect of the issue and transfer of the Equity Shares, as the case may be, and the execution of this Agreement shall be paid by the Company. The initial draft share holder agreement will be drafted by the company.</p>	<p>Each of them will pay the costs incurred by them. The initial draft agreement will be prepared by the Company and post execution all the other charges will be borne by the Company.</p>