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STRUCTURED EXITS: A NEW UNIVERSE OF POTENTIAL FUNDING FOR COMPANIES IN UNDERSERVED MARKETS

BY DAVID GITLIN

The term "structured exits" refers to a variety of investment structures designed to allow an investor to invest in a company primarily in reliance upon the target's anticipated cash flow, and not necessarily upon the occurrence of a traditional exit, such as a sale or an IPO. Structured exits broaden the pool of worthy investment targets that may be funded by allowing investors to get a desired return on their investment from companies that would not be expected to have a significant exit, or perhaps not have an exit at all.

While an obvious target for a structured exit investment is the so-called "impact investment", this is not necessarily the only type of company that would benefit from a structured exit investment.

An impact investment is an investment, for profit, in a company that fulfills a desired social mission. By making an impact investment, the investor seeks to "do well by doing good". The number of impact investments has grown exponentially in the last decade, with many angel groups, family offices, venture capital funds and corporate captive investment funds dedicating themselves exclusively, or primarily, to investing in companies with a social mission. It is also highly popular with the millennial MBA crowd and thus likely to become even more widespread. While many of those companies will grow and exit in the traditional way, many more are not expected to have a realistic opportunity for a traditional successful exit through acquisition or IPO. Through structured exit investments, an investor can fulfill its social mission by backing the "right" company and, if the venture is successful, achieve a desired return on its investment, often in a shorter time frame than a typical investment based on the traditional venture model. This could allow the investor to recycle those funds to additional investments in its social field of choice.

A structured exit investment can be structured with a wide variety of permutations designed to fit the particular goals of both the target company and the investor. Moreover, this type of investment is suitable not only for an impact investment, but to any number of deserving commercial enterprises seeking funding. For example, the target company may be an extremely appealing investment but for the fact that the founder's vision is to build a great business to pass on to his children and a traditional exit is not likely to happen anytime soon, or at least not soon enough for the investor seeking a return of its investment.

In another example, a company may have an appealing product or service that, in the investor's mind, is likely to generate good cash flows but may not reach the sales level necessary, to elicit sufficient interest from prospective buyers to give an early investor a good return after dilution is taken into consideration. It is no secret that reliance on a traditional exit for adequate returns is a risky business, particularly for early investors. The problem is compounded by the fact that an exiting company is likely to have had several rounds of capital invested by the time an exit occurs, each round diluting the earlier investors. Thus, even an early investor often needs a significant exit in order for the proceeds to which it is entitled to constitute a decent return on its investment.

Among the various structures that can be used in a structured exit are mandatory redemptions, demand dividends and cash-flow based loans.

A mandatory redemption structure involves a security, generally preferred stock, the terms of which provide for periodic mandatory redemptions tied, partially or in full, to the cash flow of the company. This Mandatory Redeemable Preferred structure is more suitable to a capped return based on a multiple of the original investment. For example, the total redemption value of the security could be 2.5X the original investment. The cash flow to be used for redemption purposes, or "Net Available Cash Flow", would be defined in the legal documentation as X% of the company's cash flow after reserves for agreed upon CAPEX or other dedicated expenses. As Net Available Cash Flow is generated, such amounts are used to redeem a pro rata share of the Mandatory Redeemable Preferred, until such Preferred is redeemed in full when the aggregate redemption amounts equal the 2.5X investment return. Not all the redemption obligations need to be tied to Net Available Cash Flow. The terms of the Preferred could provide for a mandatory periodic redemption based on an amount equal to a fixed percentage of the original investment, akin to a dividend rate or interest percentage, with the balance of the redemption tied to Net Available Cash Flow. Depending on the particulars of the target company and its projected cash flow, the fixed redemption amount could start shortly after the

closing of the investment, or after a grace period of months or even years from the investment date. In a mandatory redemption structure, the investor would generally benefit from the favorable tax rates presently in effect applicable to redemptions.

A demand dividend structure refers to an investment in a security, most likely preferred stock, that calls for mandatory dividends tied, in whole or in part, to cash flows of the business. Just like a mandatory redemption, the dividend could be tied entirely to Net Available Cash Flow, or could be a fixed dividend rate with excess dividends paid out of Net Available Cash Flow. Unlike a mandatory redemption, this return need not be capped. If capped, the security could be redeemed for a nominal amount once the cumulative dividends reach the cap, or the dividends could continue uncapped and indefinitely, until the security is sold in an exit or until no more cash flow is otherwise generated. Furthermore, if capped, the return could be capped at a fixed multiple of the amount invested, as discussed above with respect to a mandatory redemption, or at a progressive multiple whereby the multiple increases as time goes by.

The investor and the target company may decide that they prefer to structure their investment as debt rather than equity. Virtually all of the elements of a demand dividend discussed above can be structured as a cash flow based loan, except for one. By definition, a loan is a capped instrument. The interest rate could be tied to Net Available Cash Flow, in whole or in part; could be capped at a fixed multiple of the loan amount or to a progressive multiple, or could be structured as capped, and thus paid in full, when a certain IRR is achieved. Unlike a mandatory redemption or a demand dividend, however, interest payments will generally be taxed to the investor at ordinary income rates, but will be deductible by the company.

While choosing a structured exit transaction is largely predicated on the assumption that a traditional exit is not likely, a structured exit transaction does not necessarily mean that an investor will not benefit from an exit should there be one after all. One way of ensuring that there is such a benefit is to supplement the mandatory redemption, demand dividend or cash flow loan with an exit warrant. The exit warrant is meant to provide an additional equity kicker in the event an exit materializes. An exit warrant could be structured by allocating a portion of the investment as the purchase price for a warrant that grants the investor the right to purchase a pre-set percentage of the company or a set number of shares for nominal consideration. Another alternative is to structure the warrant as a right to purchase shares in the target company at an exercise price equal to the fair market value of those shares on the date of the investment. In either case, the warrant would expire immediately prior to the closing of the exit transaction. The pre-set percentage structure embeds in it anti-dilution protection. The percentage of the company the investor buys remains the same regardless of subsequent equity issuances by the company. The parties could agree to mitigate such anti-dilution effect by forcing the exercise of the warrant at an agreed upon time, even if an exit is not anticipated at the time of exercise. From the time the warrant is exercised and the warrant shares issued, any subsequent issuances would have a dilutive effect. If the warrants are structured such that there is no embedded anti-dilution mechanism, if the parties agree, anti-dilution protection can easily be added to the structure.

In summary, a myriad of deal components can be used to tailor an investment to the specific needs of the investor and the target company. Structured exit investments may be ideal not only for impact investments, but also for investment-worthy companies with low exit probabilities. These structures open a new universe of potential funding for companies in underserved markets without access to traditional funding sources, and a new pool of potential worthy targets for investors seeking adequate and safer returns than those afforded by the traditional venture capital business model.

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