



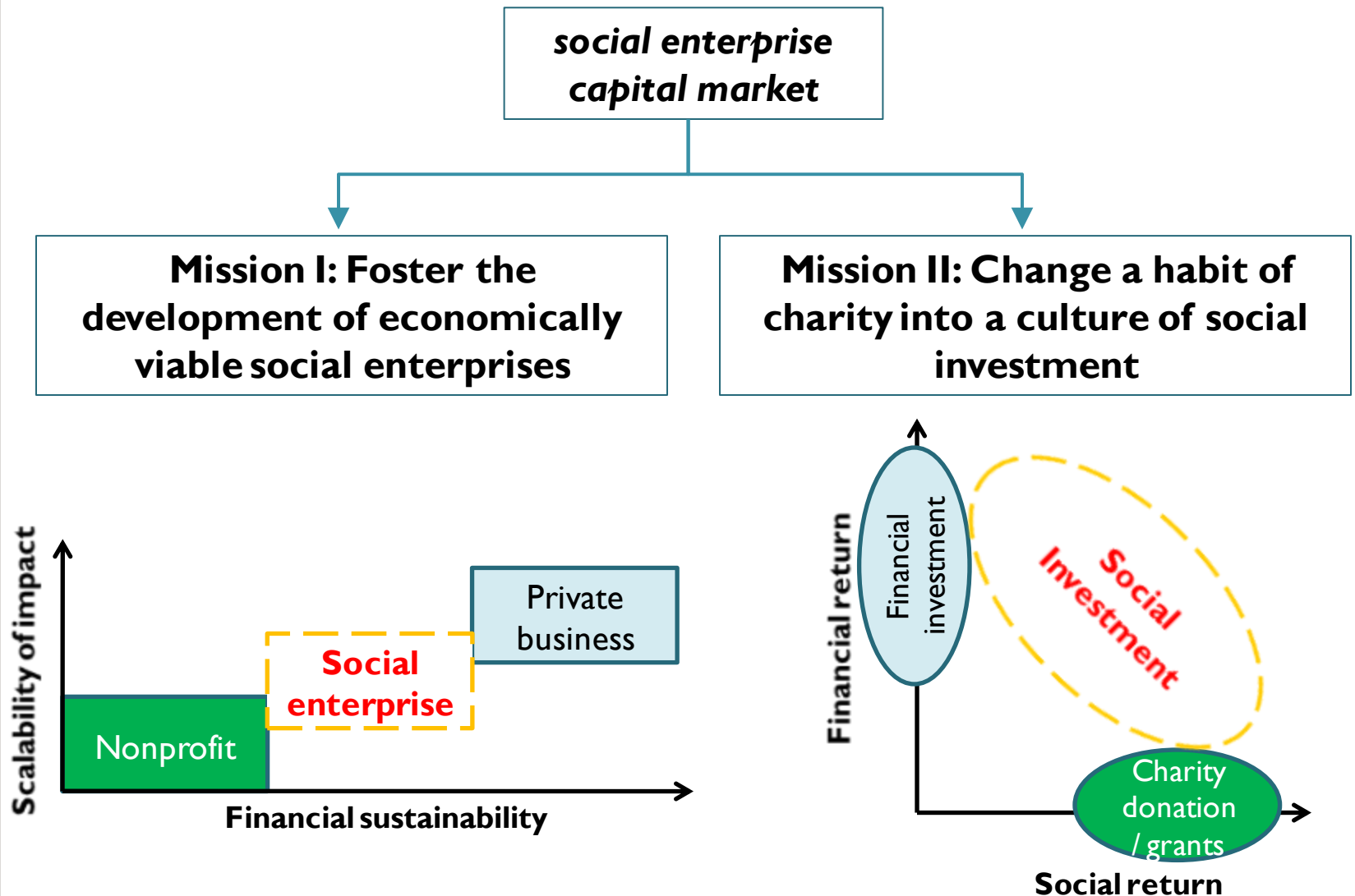
° **Designing BM&F BOVESPA social
enterprise Capital Market**

March 23 Discussion Materials

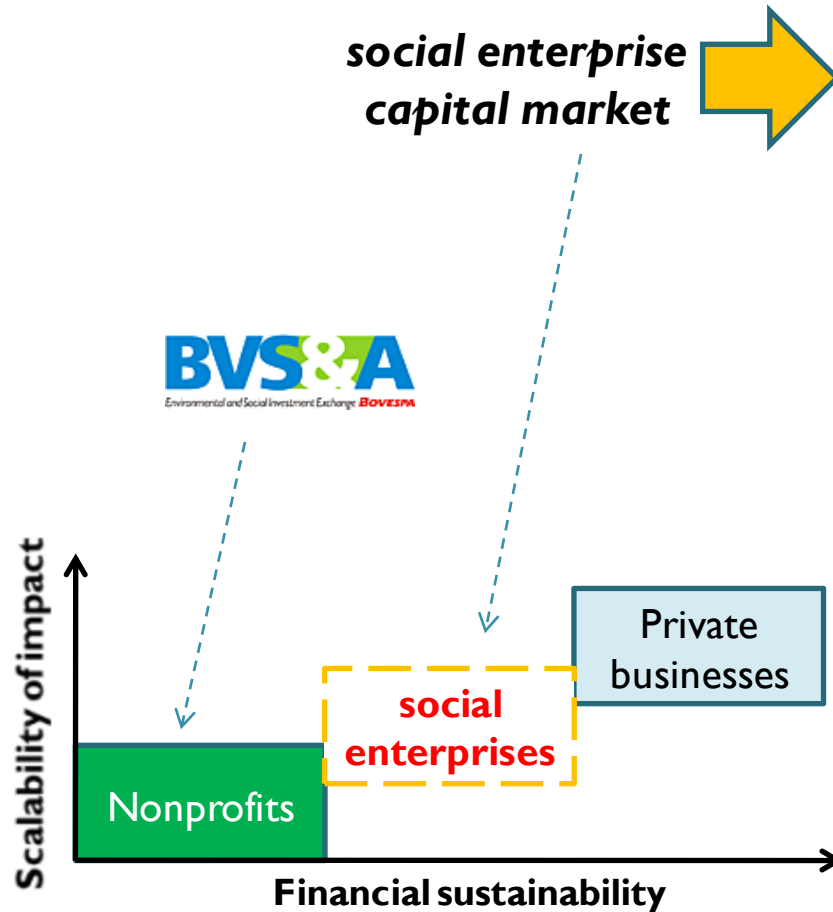
Agenda

1. Fundamental Purposes of the social enterprise Capital Market
2. Design Strategy
3. Preliminary Findings & Implications
4. Appendix

Capital market for social enterprises will be created to serve a two-pronged mission

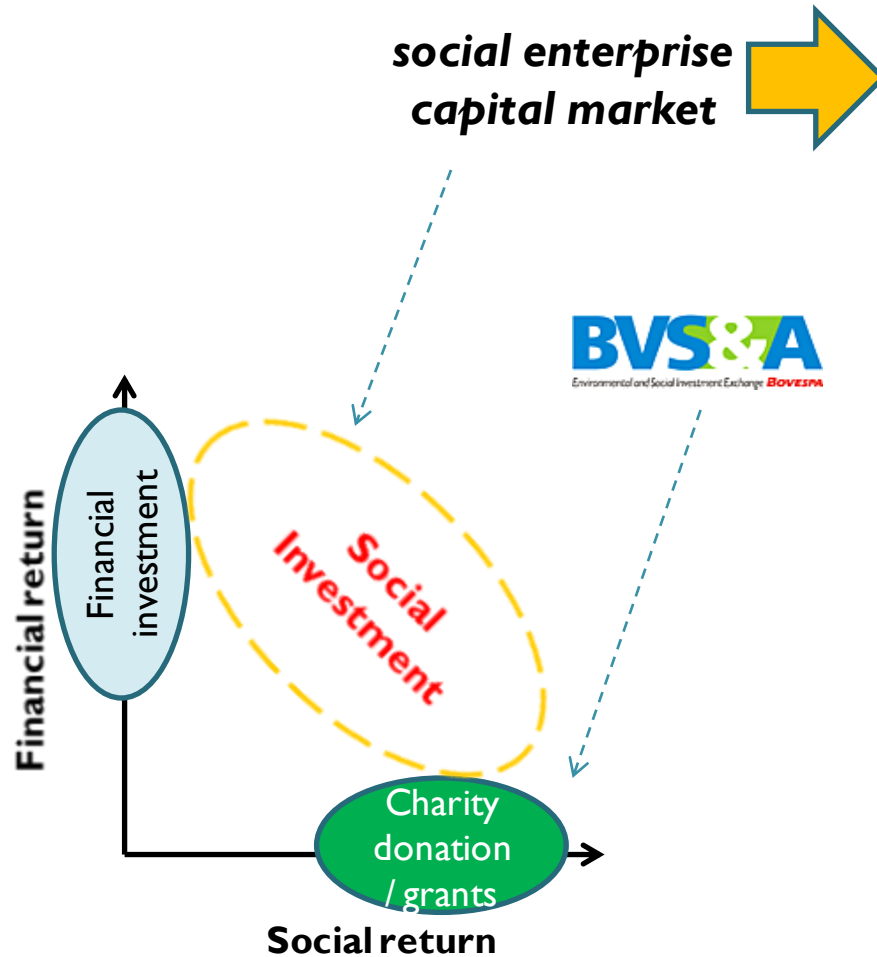


Mission I: Foster the development of economically viable social enterprises



- Make the market open to social enterprises with diverse activity focuses
- Make the pie of funds available to social sector bigger by complementing (not replacing) BVS&A
- Stimulate “coopetition” among social enterprises
 - Measurement and benchmarking of social impact
 - Network of mutual learning and information exchange

Mission II: Change a habit of charity into a culture of social investment



Key Considerations

- Make the market more accessible to broad range of investors
 - Individual as well as corporate investors
 - Overseas as well as domestic investors
- Provide adequate economic incentives to bring in those who are not interested in/can't afford to make donations
 - Repayment of principal and/or
 - Payment of dividends/interests

Two missions must be linked by aligning investors' incentives toward maximization of social return



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We should take “Market-In” approach to design the new capital market for social enterprises

Product-Out Approach

Make a product that we're good at making



Figure out who want to buy it and how we can sell to them

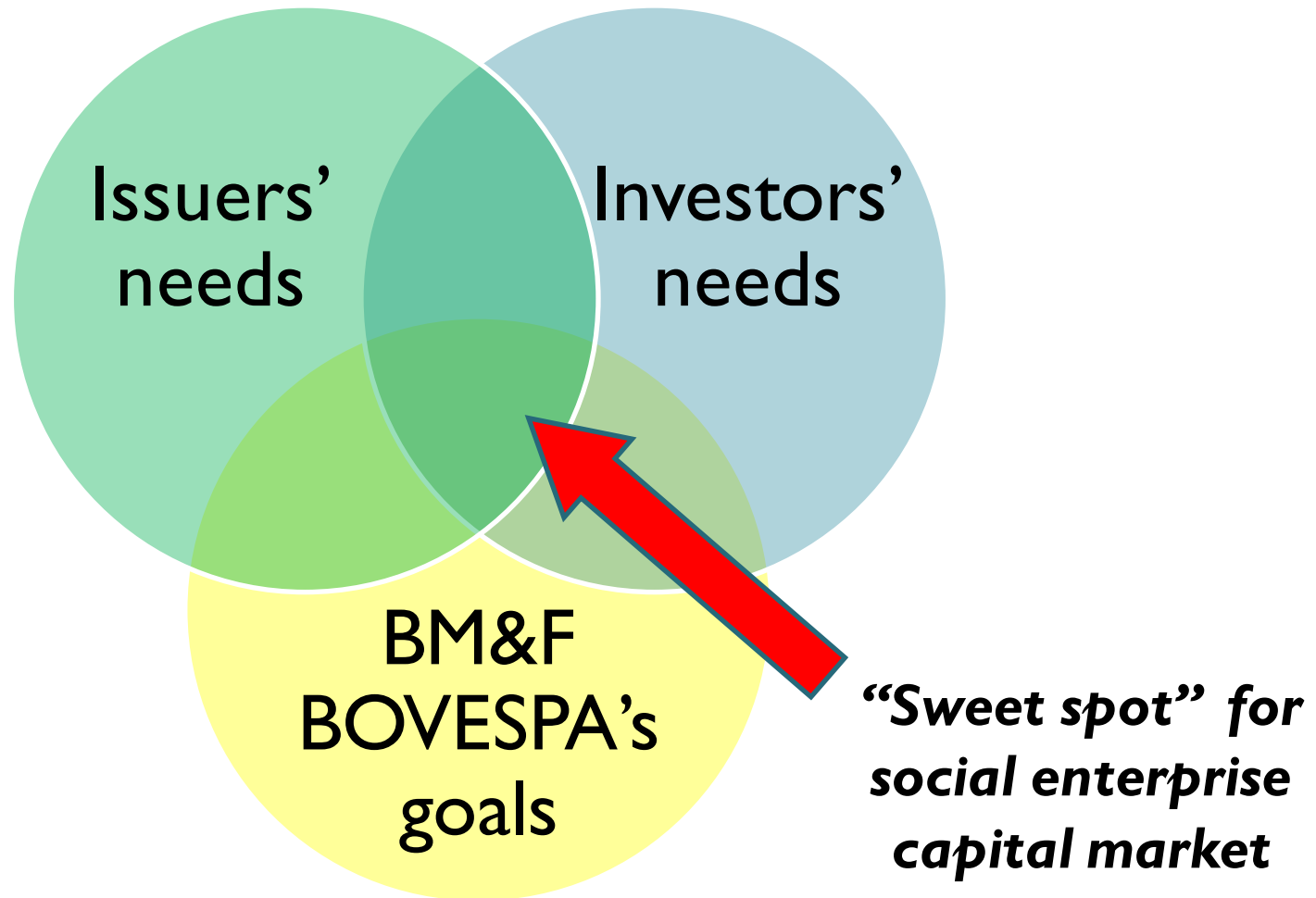
Market-In Approach

Make a product that customers want

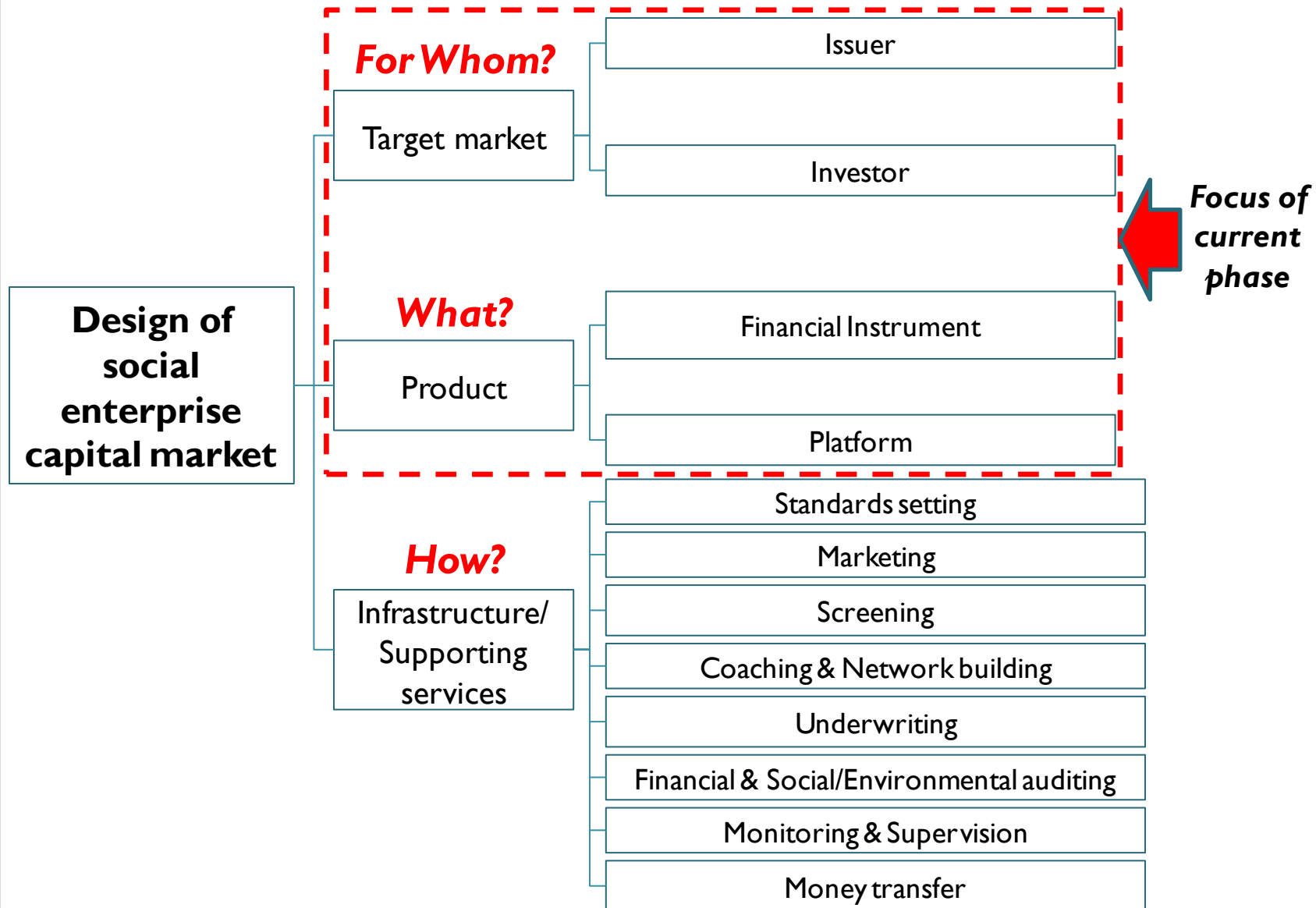


Understand what customers want and how they want to buy it

The new capital market for social enterprises will be designed to satisfy both issuers' and investors' needs



Current phase focuses on identifying target market and designing the product that satisfies their needs



Design of social enterprise capital market

For Whom?

Target market

Social Enterprise

Investor

What?

Product

Financial Instrument

Platform

How?

Infrastructure/
Supporting services

Standards setting

Marketing

Screening

Coaching & Network building

Underwriting

Financial & Social/Environmental auditing

Monitoring & Supervision

Money transfer

Key Design Variables

- Issue areas
 - Geographic areas
 - Legal status
 - Financial strength
 - Stage of development
-
- Primary motivation
 - Corporate/Individual
 - International/Domestic
-
- Equity/Debt/Mezzanine
 - Financial/Non-financial return vs Risks
 - Timeframe
 - Ownership/Control
 - Costs/Obligations
-
- Transaction channel/protocol
 - Liquidity

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Target Market: Issuer

Key Findings

- <TBC> Investors are most interested in organizations working in:
 - Early childhood education
 - Education for sustainability
 - Sustainable cities

- <TBC> Investors are most interested in organizations working in:
 - Região Sudeste
 - Região Sul
 - Região Centro-Oeste

- Being nonprofit entity has distinct advantages
- Most organizations lack sufficient financial strength/mgt capacity

Implications/Hypothesis

- Focusing initial target of SSE2.0 on environmental businesses only may not attract enough investor interests

- Focusing initial target of SSE2.0 on the geographic areas that investors are most interested in may not maximize the social impact

- SSE2.0 should be designed to be able to help nonprofit organizations with limited financial mgt capacity

Next steps

- Collect more data points through survey and interviews

- Collect more data points through survey and interviews

Target Market: Investor

Key Findings

- Interest rate on bank deposit/govt bond is higher than any financial return that social enterprises can bring to investors
- Brokers are main source of corporate funding for BVS&A but they are not very keen donors nor willing to market BVS&A to their customers
- <TBC> Corporations are tightening CSR budget and its decision making is slow

Implications/Hypothesis

- SSE2.0 can't target those investors whose primary motivation is financial return
- SSE2.0 should initially target individual donors

Next steps

- Understand the socially motivated investors' interests and needs
- Determine feasibility of targeting HNWI vs wider public
- Determine feasibility of tapping into international vs domestic investors

Product: Financial Instrument (I)

Key Findings

- Few organizations are ready to establish a separate for-profit entity to issue equity
- <TBC> Both issuers and investors seem to prefer variable interest rate that is tied to social return
- <TBC> Issuers prefer long-term capital and investors prefer short-term investment, but both seem to like the idea of extendable duration linked to social return

Implications/Hypothesis

- SSE2.0 should use debt instrument with:
 - Variable interest rate tied to social return
 - Extendable duration tied to social return

Next steps

- Collect more data points through survey and interviews
- Sound out the feasibility of the idea
- Design social return valuation methodology

Product: Financial Instrument (2)

Key Findings

- <TBC> Investors are not interested to restrict fund use to specific program as long as they can pick the organizations
- <TBC> Investors prefer financial audit plus performance report with objective and comparable social return data
- <TBC> Issuers are willing to pay 5-10% of funds raised as transaction fee, while investors prefer low initial cost and tax deduction

Implications/Hypothesis

- SSE2.0 can provide organizational-level funding rather than program-level
- Objective and comparable social return reporting is essential
- SSE2.0 can be financially sustainable by charging issuers initial fee and investors low annual fee

Next steps

- Collect more data points through survey and interviews
- Design social return valuation methodology and monitoring/audit mechanisms
- Collect more data points through survey and interviews
- Design fee pricing structure

Product: Market

Key Findings

- <TBC> Investors prefer trading through brokers to online
- <TBC> Investors prefer high liquidity through secondary market

Implications/Hypothesis

- SSE2.0 should involve brokers as channel
- SSE2.0 should consider creation of both primary and secondary market

Next steps

- Collect more data points through survey and interviews
- Design trading protocol of secondary market

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Steps to design a social enterprise capital market that suits the context of Brazil

1. Articulate the basic requirements of the social enterprise capital market
2. Map out different options that can serve the basic requirements without limiting to “stock market”
3. Clarify what we need to learn about social investors, social enterprises, Bovespa and brokers in order to determine which option works best in the context of Brazil
4. Conduct online surveys to collect information about social investors, social enterprises, Bovespa and brokers
5. Choose one or two models that fit most with the context of Brazil and work on detailed design of scheme
6. Conduct field trip to sound out the viability of the scheme design
7. Make recommendations and spell out next steps

Charity donation/grant and debt are currently the only sources of capital for social enterprises

<u>Category</u>	<u>Instrument</u>	<u>To Social Enterprise</u>	<u>To Investor</u>
Gift	<ul style="list-style-type: none"> • Donation • Grant 	Usually Inflexible w/ Least Cost	100% loss
Debt	<ul style="list-style-type: none"> • Loan • Bond 	Less Flexible w/ Lower Cost	Lower Risk
Mezzanine	<ul style="list-style-type: none"> • Subordinated loan • Subordinated bond • Preferred stock 		
Equity	<ul style="list-style-type: none"> • Common stock 	More Flexible w/ Higher Cost	Higher Risk

Different financial instruments serve different needs of social enterprises and investors

Instrument	Pros & Cons for investors	Pros & Cons for issuers	Key risks & considerations
Loan	<ul style="list-style-type: none"> • Steady, predictable interest cash flow • High priority order during bankruptcy claims • Good for working capital financing • Not particularly liquid in secondary market • Inherent upside limitation 	<ul style="list-style-type: none"> • No dilution • Low cost • Tax shield benefit with interest • Short repayment period • Restrictive covenants 	<ul style="list-style-type: none"> • Restrictive covenants • High amortization
Bond	<ul style="list-style-type: none"> • Flexible structuring of cash flows based on interest rate structure (fixed vs. variable) • Predictable cash flow • Better secondary market than for loans • High priority order during bankruptcy claims for secured bonds • Limit to upside of income as trade-off for predictable cash flows 	<ul style="list-style-type: none"> • No dilution • Low to high cost depending on type • Variety of repayment terms • Tax shield benefit with interest 	<ul style="list-style-type: none"> • Covenants • Interest rate risk uncertainty depending on structure of bond • High importance and dependence on quality of credit rating
Preferred stock	<ul style="list-style-type: none"> • Same as stock but with higher priority ranking on bankruptcy claims • Predictable, fixed statutory dividend/interest payment 	<ul style="list-style-type: none"> • Flexibility to pay interest in cash or "in-kind" with equity kicker • Good for acquisition, growth and recap financing • Dilution of control / Risk of mission drift • More limited number than equity usually that can be offered • Fixed dividend required usually 	<ul style="list-style-type: none"> • Expensive for issuer
Common stock	<ul style="list-style-type: none"> • Participation in profit • No predictable "repayment" 	<ul style="list-style-type: none"> • Permanent capital • Flexibility in use of the capital • Dividends can be cut without defaulting • Unpaid dividends do not accumulate • Dilution of control / Risk of mission drift 	<ul style="list-style-type: none"> • social enterprises must be legally allowed to distribute profits • Lack of liquidity • Administrative costs • social enterprises' lack of transparency and discipline

Different models of intermediation are possible to facilitate capital flow into social sector

		Bank	Loan securitization	Microfinance	Investment bank	Mutual fund	Private equity	Market
Instrument	Loan	X	X	X				
	Bond				X	X	X	X
	Preferred stock						X	
	Common stock				X	X	X	X
Example	<ul style="list-style-type: none"> • Nonprofit Finance Fund 	<ul style="list-style-type: none"> • Calvert Foundation Community Investment Notes • Microplace 	<ul style="list-style-type: none"> • Grameen Bank 	<ul style="list-style-type: none"> • Social Finance 	<ul style="list-style-type: none"> • Calvert Investments 	<ul style="list-style-type: none"> • Pacific Community Ventures 	<ul style="list-style-type: none"> • Triodos Ethex • Social Stock Exchange Ltd. 	
Critical functions	<ul style="list-style-type: none"> • Deposit taking/Capital raising • Assessment of credit worthiness • Lending • Collection 	<ul style="list-style-type: none"> • Pooling & repackaging instruments • Issuance • Servicing • Marketing/ Capital raising 	<ul style="list-style-type: none"> • Capital raising • Assessment of credit worthiness • Lending • Collection 	<ul style="list-style-type: none"> • Deal sourcing • Due diligence • Underwriting • Marketing/ Capital raising 	<ul style="list-style-type: none"> • Pooling & repackaging instruments • Marketing/ Capital raising 	<ul style="list-style-type: none"> • Deal sourcing • Due diligence • Capital investment • Marketing/ Capital raising 	<ul style="list-style-type: none"> • Pre-listing due diligence • Regulation & supervision 	

Essential data must be collected and analyzed in order to understand the market needs

Issuers

- Basic background data
- Capital needs
 - Amount
 - Purpose & flexibility
 - Frequency
 - Short-term vs Long-term
- Ability & willingness to repay
- Ability & willingness to pay interests/dividends
- Ability to pay administrative cost
- Willingness to partially relinquish control/ownership
- Operational transparency & fiscal discipline
- Willingness to cooperate in social return audit

Investors

- Demographics
- Motives
 - Expected financial return
 - Tangible/Measurable social return
 - Reputation
 - Other qualitative (e.g. psychological)
- Preference about issue/geographic area of issuer
- Risk tolerance
- Short-term vs Long-term
- Need for liquidity
- Preference about interface (e.g. online, brokers)

Bovespa & Brokers

- Motives
 - Social return
 - Economic
 - Innovation
- Ability & willingness to cover establishing costs

Key hypotheses must be tested through surveys in order to choose the most appropriate model

Issuers

- social enterprise and nonprofits have different needs/preferences for capital
- social enterprise at different stages have different needs/preferences for capital

Investors

- Individuals have greater upside potential as social investors in Brazil than corporations or philanthropic foundations
- The number of people who are willing to contribute to social enterprises will jump up once expected return exceeds 0%
- If investors can compare the impact of different social enterprises, they prefer to invest in those with bigger impact

Bovespa & Brokers

- Bovespa's short-term priority is on expanding a pool of domestic investors rather than exploring overseas investors