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FUNDING SOCIAL SECTOR ACTIVITY IN BRAZIL:
A CASE STUDY ANALYSIS OF AGENCY RISK INCIDENCE AND MITIGATION

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Tese apresentada à Escola de Administração de Empresas de São Paulo da Fundação Getulio Vargas, como requisito para obtenção do título de Mestre Profissional em Gestão Internacional (MPGI)

Campo de conhecimento:
Finanças e Estratégia

Orientador:Prof. Dr. Luís Henrique Pereira

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To my beloved parents Helena and Joachim Dragon
and to my wonderful brother Addy Dragon.
- the persons to whom I owe everything that I am.

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Visão sem ação não passa de sonho; ação sem visão é só passatempo; visão com ação pode mudar o mundo.

Joel Barker.

RESUMO

Empresas e organizações sociais têm um papel cada vez mais importante no mercado brasileiro. Essas organizações - sejam elas com ou sem fins lucrativos –têm como objetivocausar um profundo e positivo impacto social.Ambas enfrentamtambém o mesmo desafio: financiar as suas operações. Recentemente, dois modelos inovadores de financiamento, o fundo de *venture capital*Vox Capital e o fundo de empréstimo social SITAWI, entraram no mercado brasileiro para solucionar esse desafio. Este estudo analisa ambos os fundos,associando o problema do financiamento de empresas e organizações sociais às teorias tradicionais de negócio. Mais especificamente, por meio de um estudo de caso,é avaliado se o risco de agência (*agency risk)* explica as práticas e o *design*contratual utilizados pelos fundos. A pesquisa é baseada num estudo de Alemany e Scarlata (2010) sobre a estruturação dos negócios de fundos filantrópicos de capital empreendedor (PhVC, na sigla em inglês) na América do Norte e na Europa. Uma definição chave desse estudo é que organizações sem fins lucrativos, ao contrário daquelas com fins lucrativos, estão sujeitas a uma restrição de distribuição de lucros. Embora Alemany e Scarlata (2010) tivessem descobertoque parceria (*stewardship)*, mais do que o problema de agência (*agency problem*), explica a estrutura dos negócios dos fundos PhVC, as implicações do presente estudo de caso para o Brasil são diferentes. Os resultados sugerem que o problema de agência,mais do que a parceria,descreve adequadamente os contratos analisados de financiamento. Detectou-seque cláusulas contratuais não foram apenas usadas para mitigar o risco de agênciaresultanteda ausência de uma restrição de distribuição de lucros, mas também para reger as estruturas cooperativas com organizações sem fins lucrativos. No caso de SITAWI, a restrição dos destinatários de fundos de distribuir lucros provou-se uma ferramenta efetiva para alinhar os interesses entre os financiadores e os destinatários dos fundos. Apesar daimplicação da presença de parceria, os contratos do fundo social contiveram cláusulas geralmente usadas para reduzir o risco de agência. No caso de Vox Capital, os destinatários dos fundos eram empresas com fins lucrativos, portanto não sujeitas à restrição de distribuição de lucros. O modelo de negócio de Vox Capital é organizado para impedir qualquer incidência potencial do problema de agência. Ambos os fundos, independentemente da estrutura jurídica dos beneficiários destes fundos, evidenciaram o intuito de garantir a aplicação de práticas de negócio utilizadas pelas empresas tradicionais do setor corporativo em vez daquelas utilizadas no setor social.

Palavras-chave: Teoria de agência, teoria de parceria, empresa social, venture capital, fundo social, moral hazard.

ABSTRACT

Social and inclusive businesses play an increasingly significant role in the Brazilian market. Those organisations - whether for- or not-for-profit - share the objective of causing positive social impact. They also face a common challenge: financing their operations. Recently, two innovative funding models, the impact investment venture capital (VC) fund Vox Capital and the social fund SITAWI, have entered the Brazilian market to address this challenge. The underlying study analyses both funds by linking the problem of financing social sector activity to traditional business theory. More specifically, it assesses whether the agency risk explains the practices and the contractual design employed by the two funds through a case study approach. The research is based on a study on the deal structuring of Philanthropic Venture Capital (PhVC) models in North America and Europe by Alemany and Scarlata (2010). A key definition of this study was that not-for-profit entities, in contrast to for-profit, were characterized by a non-distribution constraint. While Alemany and Scarlata (2010) found that stewardship rather than the agency problem explains the deal structuring of those PhVC, implications for Brazil from this case study were different: Results suggested that the agency problem rather than stewardship adequately described the analysed funding agreements. Covenants were found not only to mitigate the agency risk resulting from the absence of the non-distribution constraint, but also to govern cooperative structures with not-for-profit organisations. In case of the social fund SITAWI, the non-distribution constraint of fund recipients has proven to be an effective tool to align the interests between fund provider and fund recipient. Still, this implied presence of a stewardship relationship did not rule out the application of contract features commonly used to reduce the agency risk. In the case of the impact investing VC Vox Capital, funding recipients were for-profit and thus not subject to a non-distribution constraint. Vox Capital's deal structuring models were designed so as to curb any potential incidence of the agency problem. Both funding models, independent from the legal structure of funding recipients, were found to apply business practices from the traditional corporate rather than the social sector.

Key words: Agency theory, stewardship theory, social enterprise, venture capital, social fund, moral hazard.

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TABLE OF ABBREVIATIONS AND ACRONYMS

ANDE	Aspen Network of Development Entrepreneurs
AUM	Assets under management
BoP	Bottom of the pyramid
CA-CCBC	Centro de Arbitragem da Câmara de Comércio Brasil - Canadá (Arbitration & Mediation Center of the Brazil-Canada Chamber of Commerce)
CE	Ceará, Brazil
CEMPRE	Cadastro Central de Empresas (Central registry of enterprises)
CIES	Centro de Integração de Educação e de Saúde (Center of Integration of Education and Health)
CVM	Comissão de Valores Mobiliários (Securities and Exchange Commission of Brazil)
DRE	Demonstrativos de Resultado (Annual financial report)
FASIL	Fundações Privadas e Associações sem Fins Lucrativos (Private Foundations and Not-for-profit Organisations)
FGV-EAESP	Fundação Getulio Vargas -Escola de Administração de Empresas de São Paulo
FIP	Fundo de Investimento em Participações (Private Equity Investment Funds)
GIIRS	Global Impact Investing Rating System
GIIN	Global Impact Investing Network
GRI	Global Reporting Initiative
IBGE	Instituto Brasileiro de Geografia e Estatística (Brazilian Institute for Geography and Statistics)
ICCC	Instituição Comunitária de Crédito Central (Community Institution for Central Credit)
IDB	Inter-American Development Bank
IDIS	Instituto para o Desenvolvimento do Investimento Social (Institute for Development of Social Investment)
IRIS	Impact Reporting and Investment Standards
NFP	Not-for-profit organisation
NGO	Non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
OSCIP	Organização da Sociedade Civil de Interesse Público (Civil society organisation pursuing public interests)

PhVC	Philanthropic venture capital
PR	Paraná, Brazil
RJ	Rio de Janeiro, Brazil
RP	Research proposition
RS	Rio Grande do Sul, Brazil
SE	Social enterprise
SF	Social funds
SME	Small and medium-sized enterprises
SP	São Paulo, Brazil
STD	Sexually transmitted diseases
VC	Venture capital

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1. Introduction

Social and inclusive business plays an increasingly significant role in the Brazilian market. Not only does Brazil currently experience an emergence of organisations of philanthropists and grantmakers (Thompson, Tancredi, & Kisil, 2007), but also of social enterprises (SEs) (Karnani, 2007). Those organisations, whether for- or not-for-profit, share the objective of causing positive social impact. They also face a common challenge: the challenge of financing. Apart from limited access to financial resources and a high rate of financing, doing business in Brazil is also associated with the high additional *custo brasil*[1](Sardenberg, 2012). While this already makes financing for small and medium sized enterprises (SME) in Brazil difficult, it does so even more for social enterprises. “Culturally, obtaining financial resources is an immense challenge for these entities” confirms Leonardo Letelier, the CEO of the Brazilian social fund SITAWI (personal communication, May 3, 2012)[2].

Who are the actors capable of catalysing social impact in Brazil? What are the financing needs of social enterprises and not-for-profit organisations (NFPs) in the Brazilian market? How and by whomare those needs addressed? How does financing social sector activity differ from financing in the traditional corporate sector? Are business models, practices, contractual designs, and legal structures from the corporate sector applicable in the social one? And can traditional business theory be applied in order to answer these questions?

1.1.Research objective and method

The objective of the underlying study is to respond to the research question ***whether the agency risk explains the practices and the contractual design of agreements employed by entities financing social sector activity[3] in Brazil***. A set of four research propositions (RP) embedding the Agency and the Stewardship theory and relating to the empirical study of Scarlata and Alemany (2010) provide the theoretical substructure for the research question. Light shall be shed on the relationship between fund providers on the one hand and financially backed agents aiming for the creation of social impact on the other hand. More specifically, the study focuses on moral hazard as one major incidence of the agency problem. It examines whether moral hazard adequately describes the funding relationship, and if so, how this

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[1] Particular cost of doing business associated with the Brazilian market and stemming from a poorly developed infrastructure and inefficiencies in the regulatory regimes.
[2] If not stated otherwise, any further direct citation of Leonardo Letelier refers to the interview conducted on May 3, 2012.
[3]*Social sector activity* in this study equally includes for-profit SEs.

agency risk can be mitigated through the application of business models and contractual provisions traditionally applied in the corporate sector. Although the incidence of adverse selection and hold-up will eventually be accounted for, the research and its propositions focus on the agency risk in terms of moral hazard.

The research was conducted in form of a multiple case study, first presenting and then analysing two innovative business models that have recently entered the Brazilian market in order to contribute to building a financial infrastructure for social enterprises and social sector activity. *Vox Capital* is a venture capital (VC) fund in Brazil investing in early stage and seed for-profit SEswith the mission of creating social impact. *SITAWI* is the first Brazilian social fund (SF)[4]and concedes loans at interest rates below the market rates to SEs and not-for-profit organisations in the social sector.

1.2.Relevance for scholars and practitioners

This study fills a void in business research insofar as it responds to the call of scholars for evidence on financing sources and methods for social enterprises in general (Nicholls, 2010; Austin, Stevenson & Wei-Skillern, 2006; Battle Anderson & Dees, 2006). It furthermore focuses on the Brazilian market, where research has been scarce so far (Carvalho, Netto, & Sampaio, 2012). On the side of the practitioners, this research is of particular interest for two parties: funding entities and fund recipients. For the first group, this study provides an in-depth presentation of innovative funding models entering the Brazilian market. The analysis of particularities of business models and practices is of particular interest for donors as well as investors interested in this market. More specifically, for fund providers, the study sheds light on how to detect and effectively curb moral hazard through covenants and governance structures. For the latter, not only insights in funding opportunities, but also indications on how the governance structure and the legal form of fund applicants affect their eligibility and respective funding contracts, are presented.

1.3.Chapter outline

The underlying research is structured as follows. First, contextual issues and definitions are dealt with in section 2 so as to map the actors concerned, the markets they operate in, and the challenges they face within those markets in terms of financing. Section 3 will subsequently

[4] By the time the case study was conducted, loans were the only product in SITAWI's product portfolio. Meanwhile SITAWI offers further financial services and does not refer to itself as a fund any more. As only its original funding activity, the concession of loans, is relevant to this study, the analysis focuses on SITAWI's *Fundo de Empréstimos Socias*. SITAWI will therefore still be referred to as (social).

present the paradigms, namely the Agency and the Stewardship theory, that are theoretically framing this work and those frameworks' applicability to this research. Section 4 presents the underlying methodology of this study. The subsequent section states the research question and derives the main research propositions from the theoretical frameworks of the Agency and Stewardship theory as well as theories from the VC and the banking sector. An analysis of the funding models of both financing entities, the social impact VC Vox Capital and the social loan provider SITAWI, follows. Based on this background, subsequent analysis is supposed to answer the research question by presenting the findings from qualitatively assessing the set of the four research propositions. The work closes with a summary of conclusions, the research limitations, and recommendations for further research.

2. Context and definitions: Market potential and challenges of the social sector in Brazil

Brazil has come to know significant economic weight in recent years. Having experienced an average growth far above that of the OECD countries, Brazil today is the seventh biggest economic power in terms of gross domestic product (World Bank, 2012). Apart from significant growth in the business sector, business scholars' attention recently has been drawn to a newly emerging business opportunity: social enterprises. Since the market potential of the *bottom of the pyramid*(BoP) population, a term which refers to a nation's low-income population[5], has been discovered(Prahalad, 2004) and the idea of providing micro-credits to this population became a profitable business model (Afrin, 2006), the social sector has been increasingly discussed in academic literature (Austin, 2006;Mair & Martí, 2006; Alemany &Scarlata, 2009; Battle &Anderson, 2006; Certo, 2008). Such (social) market opportunitiesexist predominantly in emerging economies. Prahalad (2004) referred to Brazil in an example: By 2003, 80% of the Brazilian populationof 184 million people were living at the BoP. For the Brazilian economy, this part of the population is crucial in terms of purchasing power, as it represents about 40% of the nation's spending capacity (Prahalad, 2003). As a response to this untapped market potential, the number ofsocial enterprisesfounded in Brazil has been evolving rapidly. By November 2011, the Aspen Network of Development Entrepreneurs (ANDE)had identified some 140 social businesses currently operating in Brazil (ANDE, 2011). One major challenge faced by social enterprises is the access to financing sources. This need is even more profound in the initial phase of the business, because such enterprises usually needscale in order to create a business that is supposed to supply the demand of a big, mostly untapped market (Brugmann & Prahalad, 2007).

While such SEs are expected to become profitable in the long run, otherorganisations aiming for social impact, like not-for-profit organisations, face an even more restrictive market when looking for financing opportunities. In 2005, the IBGE (*Instituto Brasileiro de Geografia e Estatística*) reported the existence of 338,000 officially registered FASIL (*Fundações Privadas e Associações sem Fins Lucrativos*) in Brazil. Those organisations represent 5.6% of the 6 million entities, private or public, for- or not-for-profit, composing the CEMPRE (*Cadastro Central de Empresas*) in the same year.The same census also reports that

[5]Defined as household of an income below R$ 3,034per month (http://www.voxcapital.com.br/).

organisations contributing to the country's economy and well-being are understaffed and unable to pay their employees. While 79.5% of the not-for-profit organisations do not have any paid employees, merely 6% of the sample has a staff of more than ten employees due to a lack of financial resources, among others. This first indication of the urgent need for capital in order to be sustainable and effective is underlined by the Brazilian Association of NGOsreporting that in 2008, merely about 22% of their associated NGOs disposed of a budget of above R$2 million[6](Gouveia & Daniliauskas, 2010). Furthermore, foundations in Brazil are mainly corporate ones and thus tightly linked to its core business objectives (Gouveia & Daniliauskas, 2010). This limits the endowment and support offered by those foundations to the Brazilian social sector.

Although there seems to be a promising market for creating social impact while generating economic value in Brazil, the agents in this sector are facing a major challenge: access to capital. Before presenting this challenge of financing in more detail, the operating agents in the sector who are relevant to this research will be briefly defined.

2.1.Defining theactors pursuing social impact

Social enterprises are a relatively new phenomenon in the economy. They are bridging the second and the third sector, becausesuch enterprises are not necessarily NFPs. This strategy has been referred to as operating in a hybrid sector, the 2.5 sector, which aims at alleviating poverty of the needy part of the population through approaches of sustainable and inclusive businesses (Mistura, 2011). In order to understand the financing needs of the organisations promoting social impact in Brazil, it is necessary to delimit their business models from traditional entrepreneurship as well as from NGOs and further organisations in the traditional third sector.

2.1.1. The social sector and not-for-profitorganisations

The third sector, also referred to as social sector, is broad in its facets andin its understanding including the notion of *voluntary organisations*, *NGOs*, *independent sector*, *charities* and *philanthropy*. In social sciences, this sector is used in order to refer to organisations created through civil society whose objective is not to generate profits, but to satisfy social interests. Following the classification of the first and second sector, the state and the market/corporate sector, respectively, the third sector extends to any association that does not fit within the first

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[6] About US$ 860,000, calculated at Exchange Rate End of Year, 2008: USD/BRL 2.33.

two sectors (Mânica, 2007). But, as Mânica (2007) pointed out, no legal definition of the third sector exists so far. According to article 53 of the Civil Code in Brazil, associations are legal entities formed by the grouping of two or more individuals whocollaborate so as to pursue non-economic goals. There are no mutual obligations among the associates, but between the associates and the association, there are. Pães (2006) further specifiedthat associations combine services, activities, and knowledge striving for the same objective, with or without capital, but without profitability considerations.

2.1.2. Social enterprises

The social enterprise falls somehow between the second and the third sector and therefore needs some specific consideration. As the concept of social entrepreneurship is still new, a common definition of the phenomenon has not yet been established. In academic literature, a myriad of different conceptualisations can be found. While Alvord et al. (2004) understood SEs as a catalyser for social transformation whose major objective is the alleviation of social problems, another group of scholars referred to social enterprises as non-profit organisations that are searching for alternative funding strategies or management concepts that create social value (Austin, Stevenson, & Wei-Skiller, 2006; Boschee, 1998). A third group considered social entrepreneurship as commercial business that acts socially responsible while being engaged in cross-sector partnerships (Waddock, 1988; Sagawa & Segal, 2000).

According to Mair and Martí (2006), social enterprisesare not necessarily NFPs but can equally be of for-profit nature. Not-for-profit organisations are different from those which are actually meant to generate profits in terms of their legal structure. As Hansmann (1980) argued, not-for-profit organisations are characterised by a non-distribution constraint of earned income. In this research, social enterprise can either be for- or not-for-profit entities majorly focusing on the creation of social value. Creating economic value is another feature of these enterprises as it is a necessary condition in order to become economically viable. Therefore, in the following, a broad conceptualisation will be used to refer to social enterprises: social and economic value creating, innovative organisations being both for- or not-for-profit and acting across and within the social and the corporate sector.

2.2.Financing social enterprises and social sector activity

Austin et al. (2006) considered the non-distribution constraint and the inherent striving for social value a characteristic that limits the access of not-for-profit SEsand social sector agents to traditional capital markets. The mobilisation of financial resources is a prevailing difference between social and commercial enterprises and thus requires a different mobilisation and management of financial resources. As the Bank of England (2003) reported, the limited access to capital has been identified as the main barrier to the growth of SEs. The problem is twofold: On the demand side, SEs are reluctant to apply for external financing from the corporate sector, because of their risk-aversion to borrowing. In addition, they prefer alternative, less expensive sources of financing like grants from the government or charitable foundations. This finding equally holds for agents in the traditional third sector.Thus, capitalis rarely demanded by those actors. According to Leonardo Letelier, the capital raised through grants in Brazil corresponds to only about 1% of funds available in traditional markets through debt and equity. On the supply side, commercial financial institutions are unwilling to provide debt financing because the social business is unsuitable for this financing source (Harding, 2007). This stems from the requirement of the loan applicant to provide collateral which most organisations in the third sector are unable to provide, but which is mandatory for obtaining financing from Brazilian banks. Furthermore, as Aoqui (2011) stated in its report on social entrepreneurship in Brazil, the country has the highest interest rates in the world, currently ranging at 9% with a spread between 35 and 50 percent. Also,commercial bankslack incentives to support the social sector by adapting their loan requirements to the specific needsof the social sector (SITAWI, 2012b).Thus, there is an apparent need within this sector for alternative sources of financing.

Especially in Latin America, social funds(see section 2.2.1) have been an important source of financing for the social sector. Most countries now have SFs with an average of assets under management (AUM) of US$240 million (Batkin, 2001). According to the Asian Development Bank (2001), the driving force for the increase of social funds in Latin America was the need to protect poor and low-income communities suffering from a reduction of government expenditures after structural adjustments and debt crises. As Batkin (2001) pointed out, one major drawback of this financing model is that financing is short-lived and mainly project-related while being heavily donor-dependent. These characteristics reduce the financial and institutional sustainability of such funding programs. While the traditional credit market disposes of assets of about R$1 trillion, the social sector in Brazil annually receives merely

about 1% of this amount, around R$10 billion, through donations(SITAWI, 2012b). This lack of capital reduces the success rate of projects implemented in the social sector, the sector's overall financial sustainability, and thus its potential leverage on society.

2.2.1. Business models accommodating the financing needs of social sector activity

Apart from the government and charitable organisations, new financing models for the social sector that are based on the application of for-profit entrepreneurial and finance models have recently emerged. The adaptation of the venture capital model and the introduction of social funds are two funding models that are to be presented in the following.

VC is traditionally understood as intermediation finance of entrepreneurial firms in an early stage through the provision of debt, equity, or hybrid financing (Amit, Brander & Zott, 1998). When blending the definition of Letts et al. (1997) and Edelson (2004) the Social or Philanthropic venture capital (PhVC) model is the application of the traditional VC model to the social sector in order to provide financial and hands-on support to organisations which are primarily mission-driven. With the ultimate goal of maximising social return on investment, Philanthropic venture capitalists provide intermediated investments to SEs and social sector agents. Such funds are an antidote for the traditional funding model in the social sector which, as previously stated, is short-term and project-oriented (Batkin, 2001), because it provides institutional and financial sustainability of financing. PhVCs can primarily be found in developed economies like the United States and Europe, where the model has been introduced two and one decades ago, respectively (John, 2008). In these markets, the PhVC funds are mostly non-profit organisations meaning that, independent of their legal structure, profits from investments are re-invested in the fund itself instead of being distributed among shareholders. According to this definition, only 12% of the PhVCs in the US and Europe are for-profit (Alemany & Scarlata, 2010).

In Brazil, no not-for-profit PhVC exists, so far. But, in 2009Antonio Moraes Neto, Daniel Izzo, and Kelly Michel founded Vox Capital. Vox Capital is the first VC fund in Brazil which is investing in for-profit enterprises with a profound, positive social impact through serving Brazil's low-income clients.

Social funds are another innovative approach to promote social sector activity. In her analysis, Tendler (2000, p.114) describes the objective of SFs being to "reduce poverty and unemployment and to bring services and small works projects to myriad poor communities in

a way that is decentralised, demand-driven, participatory, low in cost, and fast-disbursing."According to Batkin's (2001) definition, the schemes of SFare commonly proposed by either local organisations or the local government. These are equally responsible for the organisation, implementation and financing of the operation. The fund is administeredby a unit within a department of the government, butoutside its established administrative structure (Tendler, 2000, Batkin, 2001). The funds are grants, which are then allocated to social sector activity. In Latin America social funds emerged in the mid-1980s as a response of the government to reforms and structural adjustment programs resulting from the economic downturn, which had primarily impacted the continent's low-income community (Garrison, 2001).

In Brazil, SITAWI, the first social fund offering loans to FASIL and SEs without any ties to local organisations or the government, has been launched in 2009. This fund is non-profit and has the goal of strengthening the financial infrastructure of the third sector (Leonardo Letelier, personal communication, May 3, 2012).

3. Conceptual issues: From the Agencyto a Stewardship theory

With the increasing importance of SEs, academic literature has tried to conceptualise this business model (Austin et al., 2006; Mair & Martí, 2006) and to apply traditional business theory to it (Alemany & Scarlata, 2010). In the underlying study, the Agency theoryprovides a theoretical leverageso as to analyse the relationship between the funder and the backed organisation, being either an SE or an NFP. The following section aims at presenting this theoretical framework, which will then be used to conceptualise the agents' interaction within the social sector. Special attention will be drawn to the incidence of asymmetric information, as it will be of relevance for conceptualising the problem of financing agents in Brazil's social sector. The literature review will further be complemented by the Stewardship theory – a paradigm being complementary to the Agency theory while havinga set of different assumptions.

3.1.Agency theory

The Agency theory uses the contract between two cooperating parties in order to describe the *principal-agent relationship* (Jensen & Meckling, 1976). Under sucha contract, one person, commonly referred to as *principal,* delegates responsibility to another person, referred to as *agent*, so that a certain task is performed by the agent on behalf of the principal (Jensen & Meckling, 1976). The engagement of the agent involves the delegation of some decision-making authority from the principal to the agent. The contract is the main unit of analysis and it is assessed whether its structure should be contingent on behaviour or on outcomes (Eisenhardt, 1989a). This cooperative structure provides the general constellation for the agency problem.

The Agencyparadigm assumes that men are rational actors pursuing their own interest (Jensen & Meckling, 1976). Thus, within such structures, rational agents will base their decision-making and their organisational behaviour on considerations of personal utility maximisation and expenditure minimisation. This might result in a conflict of interests between the agents, because of the separation of ownership and control, a problem that is inherent to any employment relationship or the setting of modern corporations (Berle & Means, 1932). When corporations become too big to be managed by a single owner, the increased economic obligations will only be met through the cooperation of multiple owners (Berle & Means, 1932). Separation of ownership and control ultimately results, because the owner, the

principal,delegates some of his responsibilities to an executive, the agent. Consequently, the principal, on the one hand, benefits from the delegation of some responsibilities at the expense of a loss of information and power while bearing the financial risk (Saam, 2002). The executing agent, on the other hand, assumes this responsibility as he expects to be compensated for his effort (Conlon & Parks, 1990). A problem from this constellation arises when the principal and the agent have differing goals and the principal can only observe the outcome, but he has no information (or only at high costs) about the process of achieving the outcome (see problem of moral hazard in section 3.1.1.1) (Eisenhardt, 1989a). Another problem inherent to the principal-agent relationship is the problem of risk-sharing in cooperative structures where the individuals involved do not have the same attitude towards risk (Arrow, 1971). The principal is generally assumed to be less risk averse than the agent, because he is able to diversify his investment whereas the agent is unable to do so with his employment (Eisenhardt, 1989a). Table 1 provides a general overview about the Agency theory constellation and its main assumptions.

Table 1: Overview of Agency theory

Key idea	Cooperative structures between principal and agent should be organised so as to efficiently solve the problems of asymmetric information and risk-sharing.
Unit of analysis	Contract between principal and agent
Assumptions on individuals	Self-interested, personal utility maximising *homo economicus*, risk aversion
Assumptions on organisation	Partial goal conflict and asymmetric information among principal and agent
Assumptions on information	Information as purchasable commodity
Contracting problem	Agency (moral hazard, adverse selection and hold-up)

Source: Adapted from Eisenhardt (1989a).

The Agency theory has become a key reference for institutional and business studies and is notably divided in two branches of research – a positive (empirical) as well as a normative approach. The positive approach describes constellations under which the principal-agent conflict applies and suggests according contract designs to resolve or prevent eventual

problems (e.g. Jensen & Meckling, 1976; Jensen & Fama, 1983; Eisenhardt, 1985). Jensen andMeckling (1976) pioneered the reflection on the paradigm by contextualisingits corresponding costs resulting from the agency problem as contracts betweentwo parties with diverging interests need to be written. Those costs include structuring and monitoring costs as well as costs for bonding the contract. As these costs of fully enforcing the contract exceed the contract's benefits, they lead to a residual loss. Jensen and Fama (1983) later focused on how the agency problem could be alleviated in organisations characterised by the separation of ownership and control and how decision rules are affected by special characteristics of residual claims. Eisenhardt (1985) analysed the agency problem from an organisational perspective, concluding that it was an empirically valid perspective and that it helped to gain insights in risk, uncertainty, incentives, and information system issues for problems characterised by a cooperative structure. The goal of normatively approaching the Agency theory is to suggest a contractual design *ex ante* that minimises the agency problem.In order to do so, scholars thrive for formal mathematical solutions, which are then generally applicable to any principal-agent constellation. The results are contingent on the assumptions made to operationalize and mathematically grasp the problem (e.g. Stiglitz, 1975; Williamson, 1975; Holmström, 1979; Hart & Moore, 1994).

3.1.1. Asymmetric information

Asymmetric information is inherent to the principal-agent relationship (Fama & Jensen, 1983). When considering the normative approach to the principal-agent perspective, research can be classified into three incidences of asymmetric information, namely when the agent has an informational advantage concerning his behaviour, abilities, and his intention. Those scenarios will be referred to as agency problems ensuing from *hidden action*(Arrow, 1985), *hidden characteristics*(Akerlof, 1970),and *hidden intention*(Picot, Dietl, & Franck, 2005), respectively. The following section will present the incidence of the agency problem triggered through these three forms of asymmetric informationand a way in which it can be solved through contractual agreements.

3.1.1.1.Hidden action and moral hazard

The first incidence of asymmetric information refers to a situation of uncertainty within cooperative structures in which information concerning the agent's behaviour among two parties is unequal. In his pioneering work, Arrow (1963) referred to thisproblemas*moral hazard*. Moral hazard occurs when one party assumes undue risk because any hazard

concerning the outcome of this party's behaviour is borne by another one. Arrow (1963) coined this term using the example of an ideal insurance for medical care under the basic assumptionsof uncertainty. He further assumes that individuals act so as to maximise the value of their own utility function and that they are risk averse. Although the authorconcludes that the creation of insurances increases social welfare, a major problem of such insurances is the resulting *moral hazard*: Insurances are supposed to protect individuals against events which are out of their control and might negatively impact them. Still, such insurances might at the same time negatively impact the individual's incentives insofar as, after having taken out the insurance, part of the risk is borne by the insuring party. This risk sharing induces the individual to behave more opportunistically and less carefully (Stiglitz, 1975). In a consecutive work, Arrow (1984) generalised the concept of moral hazard referring to it as *hidden action*, as the term moral hazard by then referred to the specific case of insurance, only.

Subsequently, the problem of hidden action has been widely studied by scholars until today from a general principal-agent perspective, becausethe structure is virtually universally applicable to any interaction in the economy (Arrow, 1985). Scholars prescribe two basic conditions in order to expound the problem. First, the principal cannot directly observe the action of the agent. Second, the agent majorly, but not entirely, determines the outcome of his action. This implies the presence of exogenous risk (Arrow, 1985).Assuming further that every individualis a utility maximiser, the principal's and the agent's goals might not coincide as the cooperating parties tend to have different utility functions (Eisenhardt, 1985). For the principal this is difficult to know *ex ante,* before contracting the agent. This situation of asymmetric information might ultimately induce the agent to behave opportunistically at the expense of the principal (Chade & de Serio, 2002).

In order to prevent such behaviour, Arrow (1963) called for third-party or institutional control over the agent. Demsetz and Lehn (1985) supported this idea arguing that a prudent principal would use governance structures in order to curb the problem of potential opportunism by the agent. This control necessarily induces a certain cost, the *agency cost* resulting from the principal's expenditure for monitoring (Jensen & Meckling, 1976). As understood by Jensen and Meckling (1976), monitoring is not merely the act of measuring and observing the agent's behaviour but equally includes the principal's efforts to write contracts so as to formalise controlling and monitoring governance mechanisms like budget restrictions, compensation policies, or operating rules. Holmström and Milgrom (1987) normatively operationalised the

agency problem through the LEN model which assumes **l**inear contracts[7], an **e**xponential utility function of the agent to account for the agent's assumed risk-aversion, and **n**ormally distributed noise terms. The application of this model was illustrated by Kräkel (2007) and demonstrates another solution to mitigate the problem of hidden action. According to the LEN-model, contracts should be designed in a way as to make the agent participate in the principal's outcome. Through this result sharing, the interests of both parties converge and opportunistic behaviour of the agent is curbed.

Apart from the traditional application of the problem of hidden action in the insurance market (e.g. Arrow, 1963), the paradigm has become the main reference to theoretically frame employment relationships and to analyse the underlying contractual arrangements under which workers sell their service to their employer. In this respect, increasing attention has been paid to the question of how to design the agent's compensation scheme being mainly determined by the risk aversion of the individuals involved, effort supply elasticities, as well as the extent and nature of uncertainty, and of monitoring structures (Stiglitz, 1975).

3.1.1.2.Hidden characteristics and adverse selection

Asymmetric information can equally relate to the quality of a product or service, or the ability of an agent. This idea of linking uncertainty with quality has first been conceptually grasped by Akerlof's market for "Lemons" (1970), where he explainedwhy this will lead to market failure:

> There are many markets in which buyers use some market statistic to judge the quality of prospective purchases. In this case there is incentive for sellers to market poor quality merchandise, since the returns for good quality accrue mainly to the entire group whose statistic is affected rather than to the individual seller. As a result there tends to be a reduction in the average quality of goods and also in the size of the market. (Akerlof, 1970, p.488)

Akerlof (1970) used the example of the car market to show how bad quality products drive good quality products out of the market when asymmetric information on the product's characteristics prevails,because it induces sellers to offer bad rather than good quality. They do so, because the buyers will not be able to tell the difference between cars of good and bad quality anyways and thus are not willing to pay a higher price for higher quality. So, all cars will be offered at the same price. Since Akerlof (1970), the *lemons principle* or *adverse selection problem*, as commonly referred to, has been applied by scholars in different markets.

[7]Production function, payoff-scheme and utility function of the principal (being risk-neutral).

Petersen (2007)explained the incidence of adverse selection in the credit market, where the lender has no or only limited information about the creditworthiness of the borrower. In such a market, borrowers with a high probability of paying back the loan and those with a low probability of honouring their debt coexist. Theoretically, the higher the risk of default of the borrower, the higher the risk premium and thus the interest rates charged on the borrower. However,as uncertainty is inherent to the credit market, the lender will charge an average interest rate based on the average default risk. As this implies that some borrowers will have to pay too high interests for their high creditworthiness, they are crowded out by clients with higher default rates. The*lemons principle* also applies to the VC market with respect to the entrepreneur's ability to create value through the creation and management of his venture (Amit, 1993). Here, the ability or the service offered is subject to characteristics, which are unknown to the investor *ex ante*.

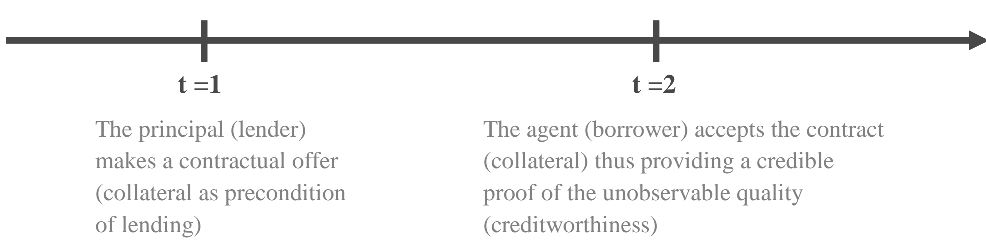
In game theory, two solutions are suggested in order to mitigate the informational disadvantage of the principal. First, Petersen (2007) suggestedusing a s*creening* or *self-selection* approach. This means that the principal designs a contractthat distinguishes between agents with high and those with low quality in terms of their ability. The conditions for a successful screening or self-selection are that accepting the contract is only profitable for an agent whose performance is not poor. In the traditional sales market offering a contract that gives the buyer the right of devolution would be an example for this solution. The approach of s*ignalling*, as presented by Walwei (2001)is based on Akerlof's (1970) reasoning that institutions providing guarantees or certificates can counteract the negative effects of quality uncertainty. An institutionalised guarantee or certification is a proof of quality as there is a risk transfer from the principal to the agent.Such a signalling approach can merely be successful, if the investment in a certificate is only profitable for an agent who is offering a product, service or ability of the expected quality. This solution can be presented in a sequential game of two periods within the setting of a sales market. In the case of screening/self-selection, the uninformed party, the buyer, acts first by making a contractual offer that is only profitable for a seller offering high quality products or services. Through accepting the contract, the seller provides a credible proof of quality. On the contrary, in the case of signalling, the informed party acts first. The seller invests in a signal through which he credibly presents the unobservable quality of his offer. This investment is also referred to as bonding costs (Jensen & Meckling, 1976). In a second step, the buyer makes the purchasing decision based on the signal, because the agent assures that he will not take actions that might

be harmful to the principal. Otherwise, the principal would have the right to be compensated for the agent’s opportunism. Figure 1 illustrates this sequential game using the example of the credit market where the borrower (agent) agrees on the provision on collateral to signal the lender (principal) his *a priori*unobservable creditworthiness (characteristics).

Figure 1: Solutions to mitigate adverse selectionin the credit market

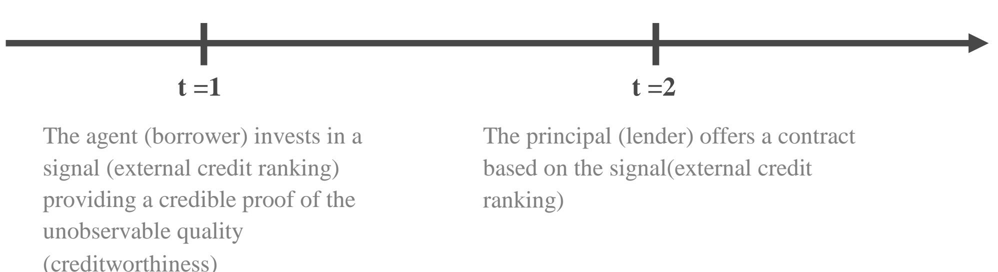
Screening/self-selection

- The uninformed party acts first



Signalling

- The informed party acts first



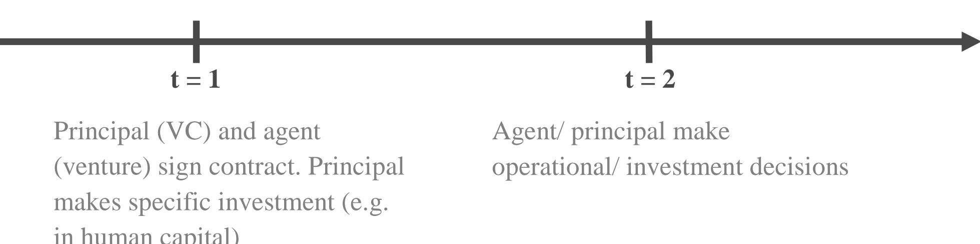
Source: Adapted from Pull (2008).

The two ways of mitigating the problem of quality uncertainty mentioned in the previous section can be understood as an institutionalised approach to generate trust between the two parties. Trust can furthermore be generated through long-term relations. Still, Ockenfels (2002) pointed out that reciprocal and repeated interaction between the involved parties was not a necessary precondition for establishing trust. Both parties will also come to an agreement in first-time interactions, if the uninformed party has access to any external information about the other party. This information can be third-party feedback or an established reputation of the informed party, signalled for instance through a brand name (Akerlof, 1970).

3.1.1.3.Hidden intention and hold-up

Lastly, the uninformed party within a cooperative structure can also suffer from the *hold-up* problem resulting from the principal's uncertainty about the intention of the agent*ex-post*(Picot, Dietl, & Franck, 2005). In this scenario, despite the principal's ability to observe the opportunistic behaviour of the agent, he cannot prevent it. The hold-up problem results from specific investments *and* imperfect contracts as shown byWilliamson (1975): One party undertakes a productive activity and thus incurs a cost, which will not be considered by the other party in a subsequent negotiation, because it is consideredas sunk cost. This might prevent the former agent from undertaking the productive activity and thus results in under-investment. Hart and Moore (1994) applied the hold-up problem to an entrepreneur with a profitable investment project but lacking financial resources. An external investorparticipating in the project bears the risk of hold-up as the entrepreneur might withdraw from the project after the investment. The investor would thus incur a loss through his specific investment in the entrepreneur's human capital. This example of hold-up describing the risk of the investor in the VC market is conceptualised in figure 2 as a sequential game with two periods.

Figure 2: Hold-up constellationin the VC market



Source: Adapted from Picot, Dietl, & Franck (2005).

The decisionsmade in t = 2 concerning the operations and eventual subsequent investments cannot bedefined through the contract in t = 1, because the outcomein t = 2 is subject to exogenous risk and unknown to both parties in the moment of signing the contract. The decisions on the specific investments in t = 1 cannot be set through the contract either, because they are judicially not verifiable (Picot et al., 2005).

In literature, two main solutions to approach the hold-up problem are discussed. Integration is either understood as (i) convergence of interests or as (ii) distribution of decision-makingrights. Pull (2008)presented integration as a cooperative structure between two

companies relying on each other’s services. Once both of these parties adhere to the same owner, their interests converge, because any right of disposition on specific investments is under the discretion of one owner only. This mitigates the conflict arising from diverging interests and explains notably the creation of organisations and companies. Integration as Grossman and Hart (1986) presented it, suggests that decision-making rights on existing resources in a cooperative structure should be distributed according to the importance of the specific investments made. According to their model, decision-making rights improve the negotiator’s position *ex post* while increasing *ex ante* incentives to make specific investments.

Table 2 provides an overview of the major incidences of asymmetric information problems within cooperative structures as well as the contractual or organisational provisions commonly deployed to alleviate the agency problem.

Table 2: Conceptual overview on problems of and solutions to the agency problem

Agency problem due to asymmetric information		**Potential Problem**	**Contractual solution**	**Main reference**	**Applicable fields**
Hidden action	Outcome of action is observable, but productive input (e.g. effort) is not: process is not deterministic (exogenous risk exists) and agent is risk-averse	**Moral Hazard**, *ex-post*	**Monitoring, interest convergence** (LEN model)	Arrow (1963; 1985) Holmström & Milgrom (1987)	i.e. insurance market, employment and/or delegation relationship
Hidden charac-teristics	Agent has more information on invariable characteristics of the agent himself or the offered service	**Adverse Selection**, *ex-ante*	**Screening**(princip al/agent) or **Signalling** (agent)	Akerlof (1970) Stiglitz (1975)	i.e. credit and insurance market
Hidden intention	Agent has more information on his intentions. Principal can observe but he cannot prevent agent’s opportunistic behaviour. Results from specific investments and imperfect contracts	**Hold-up**, *ex-post*	**Integration**, distribution of decision-making rights	Williamson (1975), Milgrom & Roberts (1992)	i.e. VC market

Source: Adapted from Picot, Dietl, & Franck (2005).

3.2.Stewardship theory

Some scholars have pointed out limitations of the Agency theory claiming that the conceptualisation of man was too simplified and insufficiently reflected the complexity of human behaviour (Jensen & Meckling, 1994; Doucouliagos, 1994). The assumption of the individual being a utility-maximiser is especially criticised as being over-generalised for means of mathematically modelling the agency problem (Hirsch, Michaels & Friedmann, 1987; Perrow, 1986). As Davis et al. (1997) argued, the assumption of man being a self-serving, opportunistic, and individualistic *homo economicus*does not necessarily hold in every cooperative structure. This argument marked the advent of the Stewardship theory, which claims that principal and agent do not always engage in opportunistic behaviour and that their interests might even converge.

This alternative theoretical approach analyses cooperative structures under non-economic assumptions (Doucouliagos, 1994). In contrast to the Agency theory, in this theoretical approach, the agent acts as a steward trying to align his decision-making as well as his behaviour with the principal's interests (Donaldson & Davis, 1991). The agent does so, because he derives higher utility from pro-organisational and collectivistic behaviour than from self-serving and individualistic action (Davis et al., 1997). This attitude results in the agent's company-centred and cooperative behaviour as he is trying to achieve organisational, collectivistic goals.

Like in the Agency theory, governance structure plays an important role in conditioning the steward's behaviour. If the assumptions of the Stewardship theory hold, effective action and performance of the agent will be maximised when empowering governance structures are designed accordingly (Davis et al., 1997). The deliberate extension of the agent's autonomy and discretion will contribute to achieving the organisational goals, because the steward can be trusted to act in line with the organisation's objectives. As Argyris (1964) argued, deploying monitoring and controlling mechanisms would even be counterproductive because it would reduce the steward's motivation.

3.3.Applicability of the conceptual frameworks

Whether the Agency or the Stewardship theory better serves to explain cooperative structures, and the according design of governance structures and contractual agreements has been widely discussed among scholars. Empirical findings suggest mixed results. While, for instance, Rechner and Dalton (1991) or Daily and Dalton (1994) found that monitoring structures following the prescription of the Agency theory would maximise corporate performance, Finkelstein and D'Aveni's findings (1994) suggested that applying the stewardship's empowering approach led to higher performance. Therefore Daviset al. (1997) concluded that both theories will be needed in order to describe the principal-agent relationship and that the applicability of the theory depends on the extent to which principals are willing to assume risk with their wealth.

Therefore, in this analysis, both theoretical frameworks will be used. The Agency theory and the Stewardship theory are going to be applied beyond the traditional setting of a corporation. In the underlying setting, the provider of funds, Vox Capital and SITAWI, can be understood as principals, because they are in the position of ownership. Their clients, the financially backed social enterprises and non-profit organisations, are agents insofar as they receive funds which they are supposed to manage and return according to the conditions set in the contractual agreement that formally links both parties. The way in which the contractual agreement is structured depends on the assumptions about the principal's risk-aversion and the degree of trust among the parties.

3.3.1. Applicability of the Agency theory

First, Barney and Ouchi (1986) applied the Agency paradigm to capital markets and Fama (1980) has used the theory in the traditional field of finance. The problem of asymmetric information and moral hazard in the credit market has been widely studied in the last 30 years (e.g. Chan & Thakor, 1987; Stiglitz & Weiss, 1981; Igawa & Kanatas, 1990). Later, Alemany and Scarlata (2010) showed that the Agency theory was also applicable in the social sector.

In the case of Vox Capital, the venture capital model is deployed. Asymmetric information is a key characteristic of the traditional VC model, because the investor has less information on the entrepreneur's capacity to innovatively combine tangible and intangible assets in order to meet the demand of customers (Amit, 1998). Given the presence of asymmetric

informationwithin the contractually defined relationship between the VC and its investments, the Agency theory isapplicable to Vox Capital (Sahlman, 1990).

SITAWIis a social fund providing loans to SEs and social sector agents. Althoughthe fund grants more agility for disbursement than do agents in the traditional banking sector, the fund does not provide any grant financing or forgives loans. Insofarit can be understood as a borrower to which credit market theory applies. The credit market is *a priori* characterised by asymmetric information because lenders have less information on the borrowers' default risk than the latter ones themselves (Igawa & Kanatas, 1990). The pricing of loans through interest rates affects the action of the credit applicants, because an increase in the interest rate lowers the borrower's project return (Stiglitz & Weiss, 1981). As Stiglitz and Weiss (1981) found out, this induces firms to choose riskier projects, because the rate of return is higher if such projects succeed. Still, as these projects are characterised by a higher risk, borrowers intentionally increasetheir default risk. Thus, lending activity is *a priori*subject to moral hazard by the credit applicant.

3.3.2. Applicability of the Stewardship theory

The Stewardshiptheory results from critiques of the Agency theory about the assumptions on the interest of the involved agents being oversimplified and thus not reflecting the reality (Jensen & Meckling, 1994; Doucouliagos, 1994; Hirsch et al., 1987). If thus, the principal-agent constellation remains unchanged, but the assumption concerning the utility function of the agent involved changes, Stewardship theory will be applicable for any case where the Agency paradigm applies.

In the case of Vox Capital, venture capital is provided to for-profit companies that serve the low-income community and have the ultimate objective of poverty alleviation in Brazil. If the goals of the fund's portfolio companies, the agents, are aligned with the ones of Vox Capital, the principal, Stewardship theory will apply.

Likewise, Stewardship theory will apply to the lending activity of SITAWI if its clients' goal will be to provide a "direct and relevant contribution to solving social and environmental challenges in Brazil" (http://www.sitawi.net/).

4. Methodology

This research refers to the empirical study of Scarlata and Alemany (2010) on the relationship between PhilanthropicVCs and its investees as a starting point for studying the relationship between funding entities and backed SEs in Brazil. Since the study in its quantitative form is not transferable due to the contingencies of the Brazilian market (see section 4.3), the research design has been adapted accordingly. The aim of the following section is to present the researchmethod and the rationale for its application. The methodological approach in terms of the study'ssample, the data collection and the research interpretation criteria will be presented.

4.1.Multiple case study approach

This research usesthe case study approach as main method of analysis. According to Yin (2003), a case study answers the explanatory research questions "how" and "why" when examining contemporary events that are beyond the influential control of the investigator. This study's research question fits this definition, as it aims at eliciting some in-depth understanding of a sector where business research has been scarce so far. The underlying case study is used in order to retain holistic and meaningful insights in complex real-life cooperative structures.

Instead of using a single case study, a study of two cases has been applied, becausethe evidence derived from multiple cases tends to be more compelling. This makes the overall research results more robust (Herriott & Firestone, 1983). Furthermore, in order to be able to answer the research question while applying the framework of Alemany and Scarlata (2010), two different cases are necessary (see section 4.2). In accordance to the perspective of Yin (1994) the multiple case study remains within the same methodological framework as a single case study and thus uses the same research design. Table 3 summarises the main characteristics of the case study as traditional qualitative research approach.

Table 3: Traditions in qualitative research design: Case study

Focus	In-depth analysis of single and multiple case studies
Discipline origin	Political science, evaluation, urban studies, other social sciences
Data collection	Multiple sources: documents, interviews, archival records, observations
Data analysis	Description, themes, assertions
Narrative form	In-depth study of a case(s)

Source: Adapted from Creswell (1998).

4.1.1. Methodological relevance and validity of the case study approach

The case study approach has been prone to criticism among scholars. Its methodological rigor, especially concerning the validity and the reliability of research findings has been questioned (March, Sproull, & Tamuz, 1991). Nevertheless, case studies haverecently become a commonly used research tool in social and business sciences (Hamel, 1992; Gibbert, Ruigrok, & Wicki, 2008). This growing interest in the method ensues from its merit to facilitate the retention of the main characteristics of real-life incidences and toget holistic in-depth insights in complex social phenomena. Therefore, the hierarchical perception claiming that case studies were an inappropriate research strategy for describing and testing propositions and should be used for preliminary research only, has changed (Yin, 2003). Instead, Yin (2003)proposed an inclusive and pluralistic view arguing that case studies can be of explanatory, exploratory, or descriptive nature. This depends on the research question, the investigator's control on behavioural events and the temporal focus of the study (on contemporary vs. historic events).For scholars of management theory, case studies are of crucial importance, because they are built on close interaction with practitioners and thus provide relevant in-depth insights in managerial practices (Amabile et al., 2001).In line with this argument, Eisenhardt (1989b) arguedthat case studies are the most appropriate tool when exploring the relationship of key variables in early phases of newly emerging theories for business and management studies. Still, especially in the early phase of theory development, methodological rigor is crucial to avoid ripple effects when building on a case study's findings (Eisenhardt & Graebner, 2007). Therefore, when applying a case study approach, four criteria commonly need to be fulfilled so as to assure methodological rigor. According to Campbell (1975) these are internal validity, construct validity, external validity and reliability.

Gibbert, Ruigrok, and Wicki (2008) identified three measures that assure *internal validity.* Internal validity is understood as variables which are causally linked to the results. First, a clear research framework is expected in order to show the causal relationship between variable(s) and outcome(s). This study will refer to the framework used by Scarlata and Alemany (2010) in order to account for this condition.The second measure, pattern matching, calls for comparing the research outcomes to empirical findings (Eisenhardt, 1989b). Again, the empirical findings of Alemany and Scarlata (2010) will serve as pattern to comparethis study'squalitative findings with their quantitative study outcomes. Lastly, theory triangulation is expected to cross-examine the findings through the applications of various theoretical perspectives (Yin, 1994). The propositionsused to answer this study's research question were deduced from four theoretic fields of study, the Agency and the Stewardship theory as well as from research findings from the VC and the credit market (see section 5). Linking these theories to the research question through the formulation of four propositionsfacilitates a cross-examination of the findings by applying multiple theoretical perspectives.In order to assure *construct validity*, the extent to which data observation is accurate and judgement is objective (Denzin & Lincoln, 1994; Yin, 1994), this study will use different sources and strategies of data collection (see Table 3 and section 4.3). Assuring *external validity* is a major challenge of case studies in general, because no case study, single or multiple, allows for a generalisation of the results. First, assuring internal validity is a *conditio sine qua non* for external validity. In addition, the rationale for the choice of the sample will be presented (see section 4.2) so as to facilitate an external appreciation of the sampling choice as suggested by Cook and Campbell (1979). Lastly, *reliability*, that is, the conceptualisation of a case study that allows for its replication (Gibbert et al., 2008) shall be achieved through careful documentation of research data and findings as well as transparent research procedures.

4.2.Sample

Scarlata and Alemany (2010) assessed the relationship between Philanthropic venture capitalists and its investees by using a quantitative research approach. This approach is not suited in order to analyse the Brazilian market for inclusive business, as the market is still immature and the number of fund providers is too small to define a relevant sample. A recent mapping of the actors in the field of social business in Brazil conducted in November 2011 by the ANDE's Brazil chapter (2011) identified 14 investors with 6 different legal structures. Given the heterogeneity of this sample, any findings of moral hazard or stewardship risk to be biased and would thus impede to draw conclusions on the results. The immaturity of the

market and the ensuing absence of a sufficiently large sample to conduct a quantitative research further explain the choice of a qualitative case study approach focussing on two funding entities in the Brazilian market.

In order to be able to replicate the findings, *two* different kinds of funds in terms of investment target and legal structure have been studied, Vox Capital and SITAWI. Those two financing entities are comparable in terms of (i) location in order to account for potential differences in the legal environment, (ii) age so as to assure that both companies have the same experience in contractual structuring and (iii) their stage of development to facilitate control for possible bias as moral hazard tends to be higher in early stages of business development (Sapienza & Gupta, 1994). In order to draw conclusions on the moral hazard/stewardship relationship between funds and SEs, the sample is different in terms of (iv) typology with one fund being for-profit and the other not-for-profit. Furthermore, the set of backed SEs differ in terms of (v) organisational/legal form.

4.3.Research method and data collection

From the six sources commonly used as evidence for case studies (Yin, 2003), physical artefacts, participant observation, direct observation, documentation, archival notes, and interviews, this research focused on the four latter ones. This use of multiple sources facilitated a better triangulation of the collected data, because it allowed for the development of *converging lines of inquiry* (Yin, 2003). The documentary information, namely the analysis of the contracts, was of particular importance in this case study, because it facilitated the linking between the research question and the data. This logic link ensues from the Agency theory being the underlying framework of the research question. This theoretical framework uses the contract as main unit of analysis (see section 3.1). In order to pursue a consistent line of inquiry, interviews have been conducted through a *focused interview* approach (Merton, Fiske,& Kendall, 1990). An approach using a semi-structured query was preferred to a guided conversation as presented by Rubin and Rubin (1995), because following a set of pre-determined questions allowed for reliable and comparable data collection. The questions followed the logic of the criteria previously identified for (i) classifying the financing entities and (ii) extracting the information relevant for each of the four research propositions (see annex 10.3 and 10.4, respectively). Although the set of questions was the same for both cases, some adaptations were necessary in order to account for the different business model of the two funding entities. Semi-structured interviews including open-ended questions as

understood by Bernard (1988) instead of response categories were used in order to gather extensive qualitative data and account for the explanatory character of this case study. During the interviews, no recording device has been used. In order to avoid the common pitfall of interviews as a source of data analysis, namely response bias and inaccuracies due to poor recall (Yin, 2003), the interviews have been transcribed and subsequently resent to the interviewed parties for cross-checking. In both cases, the funding entity's CEOs have agreed to be interviewed. The interview with Daniel Izzo of Vox Capital has been conducted in English while the interview with Leonardo Letelier ofSITAWItook place in Portuguese.An in-depth analysis of archival notes like annual reports, official websites of the funds as well as its investments/clients, and newspaper articles were further used to complement and complete the data collection.

4.4.Criteria for interpretation of findings

In order to answer the question whether moral hazard characterises the relationship between funds and backed SEs in the Brazilian social market, the frequency of formal interaction between the fund and the financially backed organisationwas used as a proxy for monitoring needs. This is based on the theoretical premise that the need for monitoring increases with an increase in the agency risk (Fama & Jensen, 1983). The frequency of the agents' interaction on a formal level was assessed through qualifying *once a year* interaction as low and *monthly* interaction as high frequency of formal interaction. *Semi-annual*, *quarterly* and *bi-monthly* interaction are interim steps on the 5-point scale between the two extreme points *once a year* and *monthly* formal interaction.

Further variables helping to answer the research question were the financial instruments (equity, convertible debt, loan) that are used by both funds,and the contractual provisions (anti-dilution, pre-emption, vesting, drag-along, tag along, and liquidation preferences in the case of the VC fund and interest rates, pay-back schemes, and collaterals in the case of the social fund) which are implemented in order to address any agency risk (see section 5). Through this research framework, internal validity as defined by Gibbert et al. (2008) shall be assured (see section 4.1.1).

5. Research question and propositions

In order to contribute to the previous discussion, the question ***whether the agency risk explains the practices and the contractual design of agreements employed by entities financing social sector activity in Brazil*** is supposed to be answered through this study. This research question is to be answered through the analysis of whether a set of four adapted research propositions based on the work of Scarlata and Alemany (2010) can be used to explain the financing constraints of agents in the Brazilian social sector. Although the incidence of adverse selection and hold-up will eventually be accounted for, the research and its propositions focus on the agency risk in terms of moral hazard.

5.1.Use of financing instruments

In the traditional VC market a broad range of financial instruments is used to supply start-up companies with capital while minimising the moral hazard problem for the investor. Staged financing is a common approach to reduce the investor's lack of information. Admati and Pfleiderer(1994) argued that through such a *fixed-fraction contract* the investor always receives a project's pay-off when reachinga certain stage and subsequently makes an investment for a future fraction of the venture's development. Through such financing agreements interim information is revealed and the investor's uncertainty is reduced.

Among scholars it has been argued that convertible preferred stock is the optimal financial instrument in VC markets. Sahlman (1988) reasoned that the venture capitalist might considerably shift some of the risk to the investee through the use of (convertible) preferred stocks. The investor receives a preferential treatment when earnings are distributed and is guaranteed seniority in case of bankruptcy of the start-up. With these prior claims the financed organisation bears a higher risk, which results in a natural selection of higher quality ventures (Sahlman, 1988). Trester (1998) furtherargued that a debt contract might induce the entrepreneur's opportunistic behaviour because it embeds a foreclosure option. For VC investments equity financing thus results to be a preferable option. Preferred (convertible) stock are found to be prevalent in the market as such contracts rule out the foreclosure option while providing the investor with prior claims. The theoretical work from Hellmann (1998), Bascha and Walz (2001), and Cornelli and Yosha (2003) notably support this reasoning.In practice, empirical evidence for the US has been convergent: Kaplan and Strömberg (2003) as well as Bergmann and Hege (1998) both found prevalence in the use of convertible preferred

stock in VC investments. However, this practice might be attributable to the national tax system (Gilson & Schizer, 2003) and thus particular for the US. For companies outside the USvarious financing instruments, like common equity, straight (nonconvertible) debt, convertible debt, convertible preferred equity, mixes of common equity and straight debt, and straight preferred equity,[8] are commonly used in the VC market (Cumming, 2005). In their research on VC funds in Europe, Cumming and Johan (2008) found evidence for the use of convertible securities, especially in the case of experienced investors. Common equity is found to be used by VC with Germany as legal origin (relative to French, Scandinavian and Socialist legal origin) and for experienced entrepreneurs. In Brazil, the market for venture capital is still in its infancy and due to a lack of data, the literature in this research field is scarce (Carvalho, Netto, & Sampaio, 2012). Therefore, no indications on the financial instruments used by VCs in Brazil could be found.

In the case of traditional bank financing, a myriad of short- and long-term financing instruments exist. Corporations are free to engage in either public or private placements of debt in their own country or by using global debt offering (Madura, 2007). This access to international financing is rather restricted to large (multinational) corporations and tends not to apply to small and medium-sized enterprises. In Brazil, the most common types of credit for SMEs are banking account overdrafts, promissory note discounts and working capital short-term loans while larger companies rely on export draft discounts, foreign loans, or vendor credits (Leal & Carvalhal da Silva, 2006).

In his analysis on financing instruments employed by PhVC funds, John (2007) found that grants were most commonly used to financially backSEs. Grants are donations given for a charitable purpose and do not have any residual claimants or return considerations by the donors. Analogously, social funds are generally financed through donor input (Batkin, 2001). SFs in Latin America provide grant funds to municipal councils or communities that would subsequently allocate these funds (in form of donation) to projects with a social or an environmental impact (Tendler, 2000). Return considerations merely consist in form of eventual accountability and reporting requirements.

From the previous discussion it has been concluded that social enterprises exhibit a preference for grant financing as it is a cheaper instrument of finance and associated with lower risk (Bank of England, 2003; section 2.2). If the funding entities thus have a propensity to offer

[8] Used in 36%, 15%, 12%, 11%, 11%, and 7%, respectively.

grants as financing instrument, this implies that rather than maximising their wealth, they are concerned about best meeting the funding needs of the SE. If then, a relatively high use of grant financing is found to be used by the fund, an alignment of interests between funder and fund recipient, and thus a low perception of moral hazard can be deduced. Therefore, the first research proposition would be

Proposition 1: The lower the perception of moral hazard by the funding entity of inclusive businesses, the higher the use of grant financing.

The term *inclusive business* in this research refers to for- and not-for-profit social enterprises as well as not-for-profit agents from the traditional social sector.

5.2.Company valuation and default risk as funding constraint

In order to appropriately structure the contract between the funder and the backed organisation, a "price" of the deal that adequately balances the fund's risk against the financing needs of the fund recipients needs to be set.

In the case of traditional VC investments, this price is determined by the valuation and evaluation of the portfolio company prior to the investment. Tyebjee and Bruno (1984) found that VCs primarily relied on subjective procedures in order to assess the company value as organisations in early stage lack an operational history. Their survey of 46 VCs revealed that a multidimensional set of criteria was used to evaluate the investment's value. The most prominent criteria were found to be management skills (89%), market size and growth (50%), rate of return (46%), market niche/position (20%), and financial history (11%).[9] MacMillan, Zemann, and Subbaranasimba (1987) identified five major classes of criteria for screening an investment. While they also find the quality of the management to be of main importance, experience, basic project viability, exposure to competition and profit erosion, and the risk of locking up the VC's investmentwere identified as further criteria to evaluate a venture. Hand (2005) underlined the value relevance of financial statements in the market for VC. This importance increases with the maturity of the investment when financial information progressively substitutes the non-financial one initially used for valuing the venture. This finding implies the underlying problem of moral hazard between the fund and the investee. The applicants might deliberately and even inadvertently choose (financial and non-financial) information and design the business plan in a way that might increase the probability of

[9] Percentage of respondents mentioning, multiple answers possible.

receiving funding, as such early-stage companies do not dispose of historical accounting data (Sahlman, 1990).

In the case of loans, the interest rate can be considered as the price set to concede lending. The pricing of debt contracts has been widely discussed among scholars: This “price” implies an evaluation of the borrowing organisation as it depends on the loan applicant’s credit worthiness and default risk (Igawa & Kanatas, 1990). As previously outlined, this constellation is subject to an inherent problem of asymmetric information and the borrower might engage into projects having a lower probability of success, but, once successful, they tend to have higher payoffs (Stiglitz & Weiss, 1981). As the lender *ex ante*has no information about the borrower’s servicing ability (and willingness), the organisation, apart from conducting a financial analysis, needs to consult credit agencies as well as previous creditors, suppliers, and/or customers to gather additional information on the loan applicant’s credit-worthiness (Ruckes, 2004). In their analysis to quantify the loan officer’s risk, McNamara and Bromiley (1997) used six financial variables, namely the loan applicants’ profitability, cash flow, liquidity, leverage, collateral margin (indicating the marketable collateral) and size.[10] This approach to assess a borrower’s default risk is commonandcomparable variables are applied among academic peers (i.e. Altman, 1968; Hoeven, 1979;Ohlson, 1980).

These valuation and default risk assessment models are industry standards in the corporate sector where moral hazard is assumed to describe the relationship between funding and backed entity. Still, if Stewardship theory applied in the cooperative structure at hand, the funding entity would rather assume a role of service than of control (Davis et al., 1997). Alemany and Scarlata (2010) then argued that, if an alignment of interests between both parties existed, rather than basing the funding decision on valuation accounting information, priority would be given to stewardship-related accounting information. This implies that, rather than assessing the value or the creditworthiness of the applicant for capital, specific need valuation will be the decisive factor when making the funding decision. Therefore,Alemany and Scarlata (2010) suggested that the higher the stewardship by the funding entity, the lower the use of enterprise valuation models would be. *Argumentum e contrario*, if the funding entities’ business models follow industry standards of the corporate sector the following proposition is to be analysed:

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[10] By using the ratio of profit before interest and taxes to total assets; the ratio of cash flow after debt amortization to total assets; the current ratio; the ratio of net worth to total assets; the ratio of net working capital to total assets; and the logarithm of total assets, respectively.

Proposition 2: The higher the perception of moral hazard by the funding entity of inclusive businesses, the higher the use of valuation and default risk assessment models.

5.3.Use of binding contractual provisions

Assuming a stewardship rather than a principal-agent relationship might also have an impact on the governance structure and contractual provision traditionally used in the VC and credit market. This is in line with Williamson's (1979) hypothesis that the risk of opportunistic behaviour triggers an increased use of contractual provisions and elaborate governance structures. Conversely, when the risk for opportunistic behaviour is low, enforcement through contracts will be less urgent.

In the VC industry, three main contractual provisions are used in order to protect the investors from opportunistic behaviour and events adversely affecting their economic well-being. These are vesting provisions, controlling rights, and renegotiation clauses. First,*vesting* provisions are supposed to address the agency problem linked to the decision-making of the entrepreneurand the approach to maximise the venture's value post-investment. Given that the VC has an informational disadvantage vis-à-vis the entrepreneur's actual effort, the extent to which the investor is exposed to the agency risk depends on how much the agent is tied financially to his business (Holmström, 1979). Furthermore, the venture's success and thus the return on the VC's investment depend to a large extent on the entrepreneur's specific human capital. Therefore, contracts will be designed in a way that leaving the venture will be more difficult for the entrepreneur (Barney et al., 1989). In the VC industry, this is commonly done through vesting provisions prescribing an increase of the entrepreneur's claim on stock options over time (Kaplan & Strömberg, 2004).This time-contingent compensation makes it more expensive for the entrepreneur to leave and thus alleviates the hold-up problem between him and the VC. Second, Kaplan and Strömberg (2004) found that contracts provided the VC with *control rights*over the cash flow management, board membership, voting and liquidation. Such rights are generally contingent on the ventures performance (financial and non-financial) meaning that the VC's control increases if the venture performs poorly. Third, Alemany and Scarlata (2010) argued that *renegotiation clauses*, like anti-dilution clauses, rights of pre-emption or liquidation as well as tag and drag along clauses, were commonly used in dynamic moral hazard settings. In their sample of VC funds, Kaplan and Strömberg (2001) found that almost 95% of the contracts included some kind of *anti-dilution* clause. Anti-dilution clauses

are used toprevent a proportional loss of the investor's share in new financing rounds with newly entering investors, because the potentially dilutive effect of issuing cheaper shares will be offset. Through such a clause, the VC investors can protect their*ex ante* investment from potentially distorting effects while constraining the need for renegotiation. *Pre-emption* refers to the investors' preferential right when a partner decides to exit the venture. The existing shareholders are conferred precedence over any other investor or the general public and will thus be able to purchase the exiting partner's stake at the least costly price (Bhagat, 1983). Through the *tag along* clause, VC investors are given the right to sell their (minority) shares on a *pro rata* basis, that is,at the same conditions as the partners or any investor with a majority stake,in case of a trade sale. *Drag along* rights, typically attributed to the VC investor, oblige any shareholder to sell its stake at the same condition as do(es) the partner(s) so as to enable a third party acquirer to purchase a majority stake in the case of a trade sale. Within the setting of moral hazard, any of these renegotiation clauses (i) preserves the VC's incentive to invest *ex ante*any time when renegotiation after the investment is possible and (ii) constrains *ex post* renegotiation and transfers (Chemla et al., 2007). AVC investor has thus an interest in contractually fixing the renegotiation clauses just presented, when perceiving a risk of moral hazard.

In the traditional credit market, moral hazard is accounted for through the design of collaterals and maturities. First, collateral can be used as means to filter among the loan applicants and thus to reduce the adverse selection problem (Besanko & Thakor, 1987), because the propensity of borrowers to make riskier investments, is reduced through the use of collateral (Stiglitz & Weiss, 1981; Bester, 1987). Bester (1994) further foundthat collateral could act as an incentive preventing the borrower from under-reporting profits. These positive effects stem from the advantage that pledging collateral is a common measure in order to reduce the lender's risk associated with the provision of a credit: *Ceteris paribus*, the lenders maintain their original claim against the borrowers while additionally being given a specific claim on the borrowers' assets (e.g. Stiglitz & Weiss 1981; Barro, 1976). Apart from the secured status, maturity is another feature of debt contracts used to alleviate the agency problem. So did Myers (1977) suggest that reducing the contract's maturity would lower the risk associated with asymmetric information. Therefore, with increasing cost of contracting, debt maturity should be shortened. According to Stohs and Mauer (1996) debt will have longer maturities for larger and well-established firms having a profile of low risk and little growth opportunities.

These examples of the use of contractual provisions support the findings that contracts are an effective tool in order to reduce moral hazard in the principal-agent relationship (Fama & Jensen, 1983). But, as argued Barney et al. (1989), governance devices and contractual provisions are costly to implement. Therefore, the funding entity needs to trade off the cost of structures facilitating monitoring and control against the probability of adverse consequences resulting from opportunism or uncertainty. The discussion resulting from proposition 1 which suggests that the risk of moral hazard is lower when funding organisation with a non-distribution constraint, equally implies that the need for covenants to govern such a funding relationship is lower. The underlying reasoning is that contractual control is less important when financing not-for-profitorganisations, because of a lowerrisk of the agent's opportunism. Conversely, for-profit SEs are expected to be subject to moral hazard and thus trigger more elaborate contractual provisions. In line with the reasoning already applied for the first two propositions, a third proposition can be formulated as follows:

> ***Proposition 3: The higher the perception of moral hazard by the funding entity of inclusive businesses, the higher the use of binding contractual provision.***

5.4.The prevalence of trust stewardship constellations

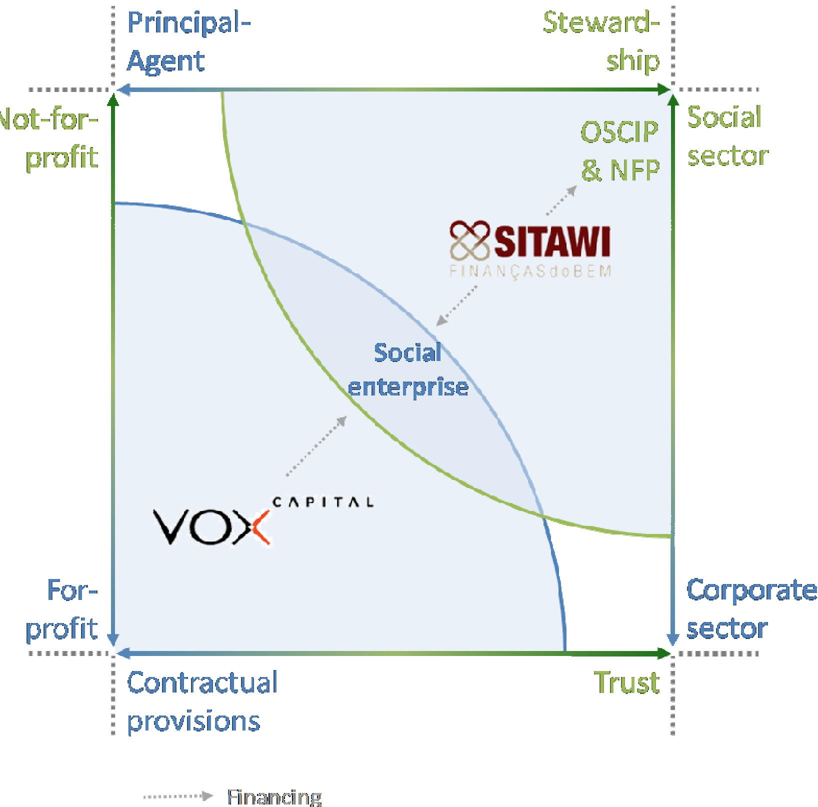
The last proposition ensues from the third one as well as from the forgone discussion. As Eisenhardt (1989) argued, Agency theory can be applied if the interests between the cooperating parties diverge. In a steward relationship the interests of the steward and the principal are aligned (Davis et al., 1997). Therefore, the cooperative structure can be characterised by mechanisms of trust. This functions as an incentive for the steward whose decision making consequently maximises the long-term benefits of the organisation. Conversely, excessive controlling provision will have a de-motivating effect and result in a less productive relationship between both parties (Argyris, 1964). As it can be expected that trust plays a more important role than contractual provisions, the last research proposition can be stated as follows:

> ***Proposition 4: The higher the stewardship offered by the funding entity of inclusive businesses, the higher the importance of trust vs. formal contractual provisions.***

Based on the reasoning for the research question and propositions a framework as illustrated by figure 3 is suggested. In this framework an overview about the main underlying assumptions on the positioning of Vox Capital and SITAWI within a multidimensional setting

of contrasting theoretical frameworks is provided. Through this framework the Agency and the Stewardship theory are plotted against their contrasting implications for applicable sector, legal structure and contractual design of funds and fund recipients.

Figure 3: Case study framework: Implications of Agencyand Stewardship theory

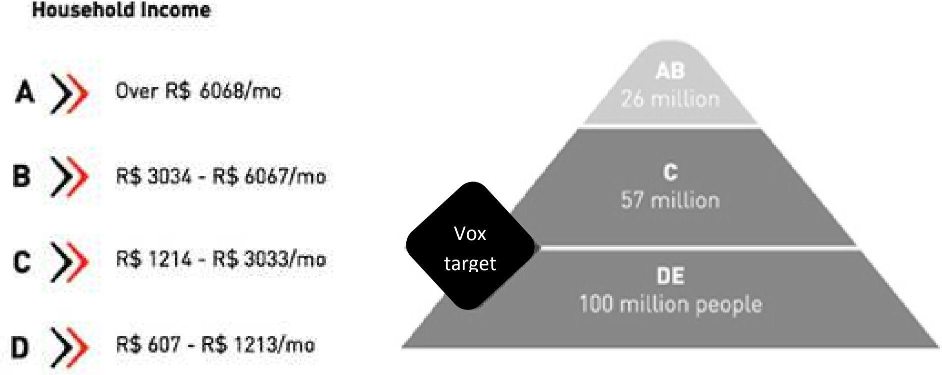


Source: The author.

6. Leveraging the VC model to scale up social enterprises – Vox Capital

In 2009, Daniel Izzo, Antonio Moraes and Kelly Michel launched Vox Capital, Brazil's first impact investing VC fund[11] with the objective to contribute to the development of a local impact-investing ecosystem. Vox Capital supports the development of innovative Brazilian businesses whose products and services primarily serve the country's low-income population, because, as Daniel Izzo (Forbes, 2012) explained, it will "only be possible to take advantage of [Brazil's] great economic momentum and of [its] current demographic bonus if we include more people in the formal economy." Therefore, Vox Capital sees its mission in leveraging the potential of the private sector. The fund focuses on enterprises which deliver solutions in the areas of healthcare, education, financial services, distribution, and housing so as to truly include the Brazilian population living at the BoP (Daniel Izzo in Forbes, 2012). These persons' living is supposed to be improved either through specific needs oriented high-quality services or through low priced products which facilitate the access to essential goods of the BoP population and simultaneously increase their purchasing power. Figure 4 depicts this targeted consumer group being composed of the social classes C, D and E and having a monthly income below R$ 3,034.

Figure 4: Vox Capital investments' target consumers



Source: Adapted from Vox Capital (http://www.voxcapital.com.br/).

6.1. Vox Capital – Fund profile

In a recent interview (Petti, n.d.) Antonio Moraes stated that, after having finished his degree of Business Administration at the FGV – EAESP, he wanted to launch a Social VC fund.

[11] Vox Capital will be referred to as *fund* in order to account for its characteristic as a financing entity. By the time of the case study, Vox Capital was still legally structured as an investment vehicle with the simple structure of a holding company, though.

Still, Vox Capital is different from what is understood as Philanthropic VC fundswhich have emerged in Europe or the US in the last two and three decades, respectively(see section 2.2.1). It might also be for this reason that Antonio Moraes speaks of the 2.5 sector instead of the third sector when referring to Vox Capital's operating field. How does the VC model applied by Vox Capital thus differ from the traditional sector and from PhVC models that can be found in North America and across Europe? The next section is supposed to shed some light on Vox Capital's innovative business model, especially in terms of its stage of development, its legal structure as well as its target investments and the funding model in general.

6.1.1. Age, stage of development and location

The three founding fathers launched Vox Capital in 2009. It started as an investment vehicle with the simple structure of a holding company and an initial investment of R$5 million by Potencia Ventures[12]. Even though fundraising remained a major concern in the first three years after this investment, the holding company became immediately operational after the capital injection form Potencia. The first financing round to external investors besides Potenciawas then initiated after a proof of concept in 2011/2012. As Daniel Izzo explained in an interview, the capital from this first financing round has by now been entirely invested and Vox Capital is currently in its second financing round, which the management team hopes to have concludedby December 2012. So far, Vox Capital has raised R$ 30 million. The company will have a first closing in August this year as this commitment is regarded as being sufficiently high for the second investment vehicle. After this closing in August, Vox Capital will become operational and start to invest the capital raised. Meanwhile the company continues with its fundraising activity, as it is aiming at scaling up its business. “We hope to be managing R$ 60 to 80 million at the end of this year,” stated Daniel Izzo(personal communication, May 21, 2012).[13]

The Vox Capital team, composed of first-time VC managers only, considers seed and early stage ventures operating in any state within Brazil's national borders. Still, the company admits to have a preference for ventures in places nearby its headquarters in São Paulo city, because any investment needs intensive and frequent interaction with the Vox Capital team.

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[12] PotenciaVentures has been founded by Kelly Michel, one of the three founding members of Vox Capital. Potencia's goal is to support innovative and system-changing business models, ventures and institutions through contributing to the development of an entrepreneurial ecosystem addressing the needs of the base of the pyramid population in Brazil.

[13] If not stated otherwise, any further direct citation of Daniel Izzo refers to the interview conducted on May 21, 2012.

Such interaction is more time-consuming with geographically distant and/or dispersed companies.

6.1.2. Legal Structure

Legally, Vox Capital is a management company structured as holding and managing the holding company Paradox Participações S.A. Daniel Izzo, the legal administrator for both entitiesexplained the advantage of this structure being that a holding is not regulated by the Brazilian CVM (*Comissão de Valores Mobiliários*). Still, as the holding structure only allows for a limited number of investor, Vox Capital is currently in a process of restructuring the fund in order to make it an FIP (*Fundo de Investimento em Participações*). The fund, once concluded, is supposed to have a life-span of ten years with R$ 60 million AUMinvested in ten ventures with an expected exit within five to seven years.

Vox Capital's founding fathers have deliberately chosen the legal structure of a for-profit company. This forms part of their *theory of change* believing that Vox Capital as a for-profit company will rather have the potential to scale up its portfolio companies' businesses. Eventually Vox Capital's portfolio companies are thus expected to reach more people at the bottom of the pyramid and lift them out of poverty.

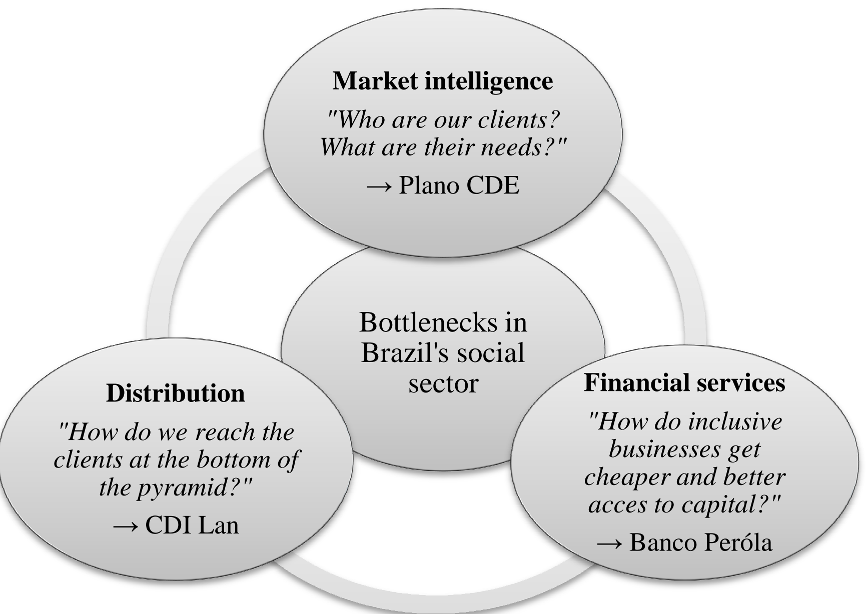
A priori Vox Capital applies the traditional venture capital approach to distribute its profits. Vox Capital charges a management fee of 2.5%. After the exit, the hurdle rate guarantees an inflation-adjusted return of 6% per year to each of Vox Capital's investors. For any return beyond the hurdle rate, Vox Capital applies a cost of carry of 20%.[14]"That is where we wanted to be creative and adapt the compensation model in a way that considered the blended value of not only financial, but social impact, also",explained Daniel Izzo. Therefore, the cost of carry of 20% for the VC management team is split up with 10% relating to the financial success of the venture while another 10% of the compensation is contingent upon whether the investment has actually generated social (or environmental) impact. This impact is assessed by applying the social and environmental impact oriented accounting standards GIIRS (Global Impact Investing Rating System). The VC's compensation will thus only exceed 10% of carry (attributable to financial performance), if Vox Capital attains a high ranking according to the GIIRS standards (see annex 10.5 and 10.6).

[14] Meaning that any return beyond the hurdle rate is split with 80% going to the investors and 20% to the VC.

6.1.3. Funding targets profile

In his interview with the *Forbes Magazin*e (May, 2012), Daniel Izzo, explained that the most important gaps when serving Brazil's BoP population are (i) market intelligence companies providing information about the actual needs and demands of the targeted population, (ii) distribution systems facilitating the access to remote communities, and (iii) the access to financial resources. Therefore, the first investments made by Vox Capital targeted these fields: *Plano CDE* delivers market intelligence while *CDI Lan* develops solutions for distribution networks and *Banco Perόla* offers financial services for Brazil's low-income population. Figure 5 provides an overview of the deficiencies in the sector as identified by Daniel Izzo and Vox Capital's according investments tackling these needs.

Figure 5: Bottlenecks in Brazil's social sector and Vox Capital's first investments.



Source: The author.

Generally, Vox Capital focuses on businesses in the fields of healthcare, education, employment generation, and housing, as depicted in figure 6. The fields of microfinance, distribution, and technology are further potential investment targets. Investments are made in early stage ventures having already developed products or service that are destined to serve Brazil's BoP population. According to Vox Capital's official website (http://www.voxcapital.com.br/), any funding applicant is expected to generate a "profound, positive social impact" while being profitable and generating significant financial return

through leveraging the scalability of its business model. Vox Capital further thoroughly assesses the venture's management team screening it for relevant skills, experience and motivation and is looking for leaders who share the vision of Vox Capital to "change the world through business" (http://www.voxcapital.com.br/).

Apart from this target group, Vox Capital also invests in the so-called *Vox Labs*.Both investments are completely different in terms of stage and structure (see section 6.1.4). Vox Labs are seed and early stage ventures serving as a formal pipeline for companiesthat will eventually become eligible for an equity investment by Vox Capital.

Figure 6: Vox Capital investment targets

Source: Vox Capital (http://www.voxcapital.com.br/).

The investment targets of Vox Capital are necessarily for-profit and rather than referring to them as social enterprises, Daniel Izzo tends to classify those ventures as "businesses with social impact". Any Vox Capital investment needs to be legally structured as limited liability company, and is thus for-profit. Naturally, this excludes an important part of actors in the social sector. Vox Capital explicitly does not invest in not-for-profit organisations, OSCIPs (*Organização da Sociedade Civil de Interesse Público)*[15], institutes and foundations. The fund does neither integrate Corporate Social Responsibility Projects, green companies, which are majorly concerned with environmental rather than social problems, nor public sector companies or initiatives in its portfolio. Although the management team underlines that the fund recognises the importance of these organisations for the Brazilian society, Vox Capital is rather understood as a vehicle to increase the awareness for (social) impact investing beyond the traditional third sector. Its mission is rather to introduce business models and approaches from the second sector in this field.

[15] Official civil society not-for-profit status recognized by the Brazilian Ministry of Justice.

6.1.4. The funding model

Vox Capital follows the traditional financing model of the VC industry. The fund supplies its portfolio companies with seed-stage and VC investments. Apart from financial support, Vox Capital also provides strategic advice and takes a hands-on approach in order to support its investment companies in their operational activity. This support function is provided by the fund's own management team as well as Vox Capital' network of highly skilled and renowned business leaders from Brazil. Vox Capital portfolio companies have full access to the fund's entire network of experts experienced in the traditional business sector. The VC Vox Capital itself takes an active role in the start-up through participating in the investee's board meetings and their decision-making on major strategic directions. The complementary composition of the fund's management team allows for the portfolio companies to benefit from a range of strategic and operational guidance in terms of legal and managerial support as well as advice on sales, marketing and personnel.

Funding is fundamentally different for Vox investments and Vox Labs. For the latter,Vox Capital does not undertake equity investments, but rather invests in form of convertible debt in relative small amounts ranging betweenR$ 50,000 and R$ 200,000. These capital injections are supposed to support the venture in the early phase of developing its business idea and structuring its operational activity. "When we first started with the Vox Labs, we were dealing with them like with any other portfolio company. Then we realised that this was consuming far too much of our time and resources," explained Daniel Izzo. Therefore, the Labs are suggested to receive professional support of Vox Capital's cooperating partner*Aceleradora de ImpactodaArtemisia*. These companies are accelerators that support impact ventures in the initial phase of their development. Financing for Vox Labs is conditional upon this cooperation. After six to twelve months Vox Capital then reconsiders the investment and decides whether to stick to the convertible debt or whether to undertake an equity investment. For this kind of investments, Vox Capital has the right of first refusal (see section 6.2.3).

6.2.Deal structuring of Vox Capital

The following section presents the deal structuring of Vox Capital in order to subsequently analyse whether the research propositions previously formulated adequately describe Vox Capital's funding model. Therefore, the deal structuring will be presented in terms of the financial instruments and company valuation methods applied. Then, light will be shed on the types of contractual agreements used to structure Vox Capital's investments and on how the VC monitors its portfolio companies.

6.2.1. Portfolio of financial instruments

So far, out of Vox Capital's six portfolio companies, three have received equity investments and three, the early stage Vox Labs, have received convertible debt as investments. Vox Capital exclusively uses convertible debt and equity as financial instruments. "Using debt for our investments in the Vox Labs is a rational choice,"stated Daniel Izzo. Through the debt investment Vox Capital avoids liabilities at a stage at which it is not yet sure, whether the VC will eventually become a partner of the venture. The interest rates charged by Vox Capital for such an investment are far below market rates, because the investment through convertible debt understood as a way of maintaining the value of the money until eventually deciding whether or not to invest in the Lab (with equity). Vox Capital furthermore benefits from a right of refusal clause and a prior claim as first investor through the debt investment, as stated in paragraph 5.1 of the shareholder agreement. Equity investments are taken into consideration only for businesses beyond the seed stage, because they are considered less risky.

6.2.2. Deal selection criteria and company valuation

Vox Capital generally evaluates its portfolio companies' qualitative as well as quantitative social impact. Qualitatively the deal-flow is screened for products and services which have the potential of generating systemic change through serving Brazil's BoP community in the areas of housing, education, healthcare, and job generation. Quantitatively, the potential of scaling up the business in order to reach as many people as possible is assessed.

The company evaluation begins with the screening process, which – in itself - is divided into three phases comparable to the traditional VC market approach. First, Vox Capital has a prior selection of the deal-flow in order to filter ventures that might be of interest. In a second step, those ventures are screened more thoroughly. Once the VC concludes that the venture might fit Vox Capital's investment criteria listed above, the due diligence (DD) begins.

The investment decision is furthermore based on four criteria. First, Vox Capital assesses (i) the management team in terms of skills, experience and fit. Another key part of the DD is the assessment of the aspirant's (ii) business model. This assessment is an in-depth analysis of the business and its target market. To conclude on the company's positioning within the market Vox Capital analyses the internal strengths and structure of the venture. In addition, it assessesthe venture'sfive market forces as identified by Porter (1979): the bargaining power of suppliers and of buyers, the threat of substitutes, the barriers to market entry, and internal rivalry. Market size, growth and potential are then further assessed. Vox Capital also analyses whether or not the venture's business model will (iii) generate social (or environmental) impact."The last criterion is quite qualitative"admitted the management during the interview. The investment aspirant is checked for the company's actual fit within the range of Vox Capital's investments. Daniel Izzo explained: "The question weask ourselves is what Vox Capital can actually provide for this company. We assess what the company actually needs and whether we can be of help in answering these needs." Vox Capital's investment decision is generally not based on the financial history of the venture, but on business plans and forecasts of the business' future development, because financial statements rarely exist at this stage of development. When asking directly for the valuation criteria as found by Tyebjee and Bruno (1984) and MacMillan et al. (1987), although not explicitly stated, Daniel Izzo confirmed that all[16] but one of the valuation criteria (risk of locking up the VC's investment) are applied by Vox Capital.

It needs to be added that Vox Capital applies fundamentally different criteria when valuing Vox investments and the Vox Labs. The assessment of potential Vox Labs is less complex and time-consuming, because in those cases there is not yet a business model, but a business idea. Vox Capital therefore rather bases its investment decision on the potential of the applicant's business idea and whether Vox Capital can contribute to its structuring and development. The Vox Lab status is thus just considered as a first phase before becoming a company of the Vox Capital portfolio. But before changing from the debt to an equity investment, Vox Capital will apply the same assessment criteria for the Vox Lab as for any other Vox investment.

[16] (i) management skills, market size and growth, rate of return, market niche/ position, and financial history and (ii) quality of the management, experience, basic project viability, exposure to competition and profit erosion, and the risk of locking up the VC's investment, respectively.

6.2.3. Contractual provisions

Vox Capital's investments are generally strategic decisions and legally reinforced through three contracts. The (i) social contract considers the partners and the partnership itself. This contract is individual for each investment. Then, Vox further issues a (ii) shareholder agreement and the (iii) investment contract. Both latter contracts are standardised and applied for every investment although they eventually need some minor investment-specific adjustments. In this section, the analysis will focus on the shareholder agreement, because this contract is commonly applied to govern private companies (Chemla et al., 2007).

The contract reflects the common structuring of a shareholder agreement as identified by Chemla et al. (2007) in terms of the termination of precedent agreements (paragraph 1.1), control provisions (paragraph 2, especially 2.2. and 2.6.), constraints on the transfer of shares (paragraphs 4.1 and 4.3), call and put options (paragraph 8) as well as non-compete clauses (paragraph 11) and agreements on arbitration and dispute resolution (paragraph 14).[17]The two latter paragraphs shall be presented in more detail.

With paragraph 11 of the shareholder agreement, *não concorrência e confidencialidade*, Vox Capital has a non-compete deal with the venture's entrepreneurs meaning that any entrepreneur who decides to leave the company will not have the right to create the same or a comparable business within the next five years. Through the last paragraph of the shareholder agreement, *arbitragem*, the shareholders agree that any issue resulting from the shareholder agreement, which cannot be solved by the affected parties themselves will follow a specified dispute resolution procedure. In line with the Lei n° 9.307 of the *Centro de Arbitragem da Câmara de Comércio Brasil - Canadá (*CA-CCBC), the agreement specifically designates the CA-CCBC as exclusive arbitrator for resolving any disagreement.

In paragraph 5, *direito de preferência*, any shareholder who offers his shares for sale to an outside investor is obliged to offer his share at equal conditions to all other existing shareholders. Only in case of refusal on the part of the shareholders, the shares can be sold to the third party investor. This paragraph prescribing the *right of first refusal* substitutes a pre-emption right which is thus not subject ofVox Capital's shareholder agreement. If the shareholders decline their preferential treatment attributed through paragraph 5, but wish to sell their shares to the potential outside buyer instead, they are granted the right to offer their

[17] As these clauses are standardized and not of primary relevance for further data analysis, a more detailed presentation of all clauses shall be deliberately omitted.

shares on the same terms and the same price as the stake of the first shareholder. This right is commonly referred to as *tag-along* right and set through paragraph 6, the co-sale agreement. Complementary, paragraph 7 prescribes the *drag-along* right. According to this paragraph, Vox Capital as selling shareholder is granted the right to buy out the stakes of all other shareholders at the same price and conditionsas the initial selling offer. Through this agreement, Vox Capital is able to deliver up to 100% of the investment to an outside acquirer. Those tag- and drag along rights can be understood as conditional put options attributed to all shareholders and call options available to the public, respectively. Put and call options in a traditional form are set through the subsequent paragraph 8, *opção de compra e venda*.

In the shareholder agreement, no indications for the application of vesting provisions or anti-dilution clauses have been found. The absence of these provisions is confirmed in the interview. Daniel Izzo explained that Vox Capital was considering the introduction of a vesting provision in future investment contracts, though.

6.2.4. Monitoring of portfolio companies

According to the second paragraph of the shareholder agreement, attributing a seat on the management board of the venture to the Vox Capital management is a precondition for becoming a Vox investment. Through this board seat, Vox Capital actively participates in the financial and strategic decision-making of the firm and has voting rights on major operational, administrative and structural issues. In line with paragraph 2.6.1, of the shareholder agreement, Vox Capital participates in any decisions on further investments, an increase in capital, the transfer of company shares and further key headquarter concerns. This active participation and integration in the investment's operation facilitates a constant monitoring of the operational and financial development of the venture.

Vox Capital generally interacts on a weekly basis with its portfolio companies to contribute to the venture's day-to-day operations. Additionally, there is a formal board meeting every month in order to discuss the venture's progress and managerial questions. This meeting on a *monthly* basis monitors forecasted versus actual company performance. *Semi-annually*, Vox Capital meets its investees for the strategic planning. According to paragraph 2.5 of the shareholder agreement, any strategic decisions taken in the meeting is to be drawn up in a protocol, so that objectives can be determined in a first meeting and then reviewed in a second meeting. The monthly and semi-annual meetings are set through the investment contract.

The interaction does not only serve as way of monitoring the ventures, though. Each Vox member has the capacity to lead up to two strategic programmes of one of the venture throughout the year. In this way, Vox Capital rather acts as a consultant than as a supervisor, helping the ventures in specific projects.

Vox Capital’s portfolio companies are monitored through a detailed analysis of their performance in terms of accounting and an actual vs. forecast analysis. Apart from the common financial criteria, Vox Capital applies the IRIS, a set of metrics developed by the Global Impact Investing Network (GIIN) to assess an organization's social, environmental, and financial performance. The VC furthermore refers to the GIIRS in order to measure the social impact generated byits investments and Vox Capital itself. This process has been started one year ago and the VC is the first Brazilian fund to conform to these accounting frameworks. An example for a GIIRS report on Vox Capital’s first fund and one of its investments can be found inannex 10.5 and 10.6, respectively.

7. Loans meeting the financing needs of Brazil's social sector - SITAWI

"Employment and income generation, environment, health, culture, and civil rights," according to SITAWI's annual report 2011, these are the major areas in which the social fund SITAWI aims to support and improve projects undertaken by organisations in the social sector. The fund's CEO Leonardo Letelier explained that SITAWI does so by contributing to the development of the financial infrastructure of Brazil's social sector through the provision of financial products and services. In his opinion, the lack of access to capital is one of the major impediments for the sector's sustainable development.[18]By the beginning of this year, SITAWI has been awarded the *2011 beyondBanking* award as best socially responsible investment and impact investing project in Latin America by the Inter-American Development Bank (IDB) (SITAWI, 2012a). What made SITAWI eligible for this award? What is the fund's business model? And what makes it so innovative and simultaneously decisively important for the development of the financial infrastructure in Brazil's social sector? Through first presenting and then classifying SITAWI according to the research propositions derivedin previous sections, light on these questions shall be shed.

7.1.SITAWI – fund profile

SITAWI is Swahili and means to prosper or to flourish, explainedLeonardo Letelier. With the ultimate goal of making the social market in Brazil prosper, the idea of the first social fund in Brazil was born. This vision droveLeonardo Letelier and his colleagues in 2006 to cope with a myriad of question. Where was SITAWI to be located and initial funds to be raised? Should the fund be designed as for- or not-for-profitorganisation? Who and where would the fund's target clients be? Which operational structure and internal funding strategy would allow for granting loans and paying the bills?

7.1.1. Age, stage of development and location

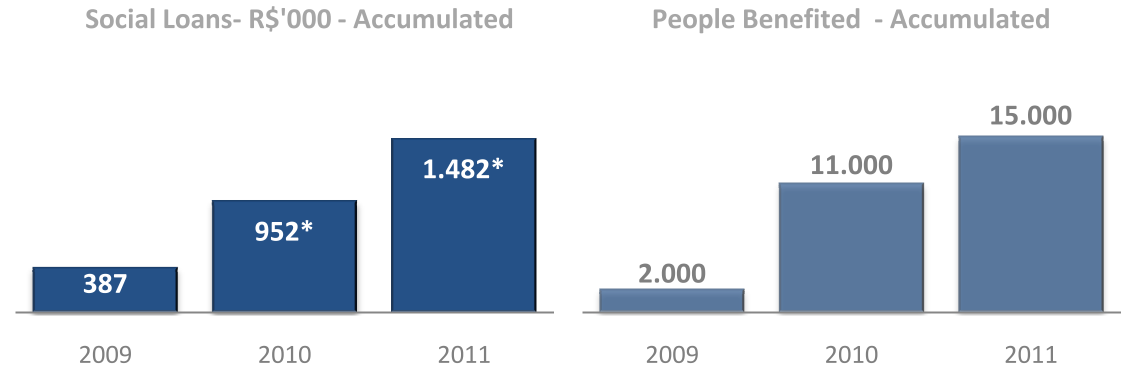
From the idea of launching a fund to officially startingSITAWI, it has been a long way. For one year and a half Leonardo Letelier and his by then team of two colleagues were offering strategic advice for actors in Brazil's social sector without issuing a single loan. In the first place, on the demand side, SEs were reluctant to apply for a loan and, on the supply side, it was difficult to find funders to support the business model – the first of its kind in the

[18] If not indicated differently, any information on SITAWI is based in the personal communication with Leonardo Letelier.

Brazilian market. When, in late 2008, still no funds were raised, but SITAWI received its first loan applications, Leonardo Letelier decided to extend the loans himself.

The fund was finally officially launched in 2009 after a major donation of the Avina Foundation. Since then, SITAWI has been operating from itsheadquarters in Rio de Janeiro. Since 2009, the social fund hasalready extendedeleven social loans of anaccumulated value of R$1.5 million (US$ 983,000)to nine organisations operating in the social sector (SITAWI, 2012a). Figure 7 shows the development of the (accumulated) loan volume over time.

Figure 7: SITAWI social loans and people benefited



(*) includes loans and credit lines, calculated with USD/BRL year end exchange rates for each respective year.

Source: Adapted from Finanças do bem – Apresentação institucional, SITAWI (2012b).

7.1.2. Legal Structure

SITAWI is legally structured as a not-for-profitorganisation. The reason for choosing this legal design has been twofold. First, as outlined in section 2.2, most actors in the social sector feel uncomfortable with the traditional financial sector and rather apply for grants from foundation than for financing from commercial banks. Naturally, those funds will feel more secure when applyingfor funding from an NFP fund. Second, operating as a not-for-profit fund strengthened the legal basis for SITAWI as fundraiser. In early 2010, the fund officially obtained the OSCIP (*Organização da Sociedade Civil de Interesse Público*) statusas defined in the Brazilian Law n°9.790 of 23rd March 1999 and awarded by the Brazilian Ministry of Justice. This status certifies SITAWI's engagement as not-for-profitorganisation pursuing the socio-economic development of Brazil. It equally acknowledges the fund's transparency, as the OSCIP status requires the disclosure of the accounting results of SITAWI. Another benefit from this status is that SITAWI donors become eligible for tax deductions when making

grants to the fund. Before the accreditation, SITAWI could only offer this tax benefit to US-based taxpayers, through a fiscal sponsor.

Since 2011, the fund's reporting standards correspond to the requirements of the Global Reporting Initiative Framework (GRI - G3, level C). This makes SITAWI a pioneer in the Brazilian market, as it is the first social entity without ties to the corporate sector that discloses its annual results according to the voluntary global reporting standards for sustainability (SITAWI, 2012a).

In its first two fiscal years of existence, SITAWI's end of year results showed a balance of netting operational costs and revenues, while in 2011 the balance sheet exhibited a deficit of R$ 72,000 due to reduced revenues from the advisory activity. Leonardo Letelier confirmed that, if any profits were generated, they were not distributed but kept in the fund in order to respond to the organisation's future expenses. SITAWI is thus a not-for-profitorganisationcharacterised by a non-distribution constraint as defined by Hansmann (1980).

7.1.3. Funding targets profile

SITAWIprimarily focuses on Brazilian "organisations for which social impact is a core mission and business is the supportive engine" (Letelier, 2011). The fund's CEO further explained that SITAWI targets the estimated 20,000 NFPs with relevant income generation activities in the fields of employment and income generation, environment, health, culture and civil rights (SITAWI, 2012b).

The fund clearly outlines five basic criteria making loan applicants eligible for their loan and advisory service. First, the social impact generated by the applicant needs to be clearly recognisable in a sense that it contributes to the social or environmental development of Brazil in a direct and pertinent way. Second, the backed organisation needs to commit itself to ethical action and high moral standards.On the operational side,SITAWI is looking for organisations that have a historic account of operations and revenue streams, ideally having been profitable in the last two years. The fundfurther demands from its applicants to have a structured approach in order to assess the current market situation and the social sector as a basis for designing a business plan that exhibits realistic social and financial objectives. Lastly, the organisation should be willing to accept and integrate the advisory support offered by SITAWI into its operating activity. This criteria's goal is to leverage the business expertise

of the fund managers and strengthen the decision-making processes within the clients'organisational structures while maintaining their independence.

SITAWI's social loans are destined for organisations that have the potential to scale up their business and are already beyond their early stage of development. The business idea is supposed to have already been implemented and the business model is expected to be structured and well developed by the time of applying for a credit line.

The focus of SITAWI lies on not-for-profitorganisations. For-profit SEs are considered only if most of the company's economic value creation is shared along the entire value chain. Under this condition, SEsthat are not subject to loans and further support from other development programmes might become eligible for a SITAWI loan.

The actual screening process of whether an applicant is eligible for the loan starts with filling in the application document. This serves as a basis to further assess the applicant's eligibility. This documentalso serves as a hurdle to deter organisations assuming that the loan was an easy substitution for a grant, explained Leonardo Letelier in the interview. According to the annual report 2011, of the eleven loans granted so far, nine have already been repaid, one is on schedule, and one is late. In 2011, the loan granted to Caspiedade needed to be restructured as the institution providing social and health care in São Paulo had difficulties in honouring their debt. In response to this incidence, SITAWI increased its advisory activity through *pro bono* consulting from McKinsey analysts in order to help the organisation managing its financial account. In response SITAWI did not entirely conform to the onus contractually prescribed but applied an alleviated manner in response to the organisation's delay. Payments resumed in early 2012."We have to walk a fine line between collecting the late debt (to be relent to the sector) and helping the organisation - there is no point in doing just what the bank would do. Then we would be a regular bank," explained SITAWI's CEO.

7.1.4. The funding model

As a not-for-profitorganisation, SITAWI is mainly grant financed. The donations received are either used for granting social loans or to support the funds internal operations. About 70% of SITAWI's AUM can be attributed to Brazilian donors. Until 2010, the advisory activity constituted another important revenue stream forfinancing the fund's internal operational expenses.In 2010, SITAWI's operating expenses were financed through the fund's consulting activity (52%), receipts from interests (33%), and donations (15%) explicitly destined to

cover operating expenses. But, as Leonardo Letelier announced in the annual report 2011, SITAWI is currently changing this financing strategy. Instead of supporting its operations through revenues from consulting, the fund will shift to fundraising as main revenue stream. The fund closed the fiscal year 2011 with R$ 747,000 AUM, thereof 76% circulating in form of extended loans by the end of fiscal year 2011. The fund until present exhibits a turnover rate of 3 implying that the “impact of every real donated to the Social Fund has been multiplied 3 times” (SITAWI, 2012a). Figure 8 summarises the development of the fund’s AUM and the revenue streams from donations since 2009.

Figure 8: SITAWI assets under management and donations

Social fund evolution through loan donations
[in k, accumulated]
R$ 188
R$ 160*
R$ 747
R$ 559
R$ 399
2009
2010
2011

(*) includes funds (R$ 114,000) from partnership with Artemisia, unter SITAWI’s management.
Source:SITAWI annual report 2011 and author.

In capital markets, SITAWI can be positioned between a bank and a foundation. Banks traditionally provide loans at market-based interest rates whereas foundations primarily concede grants. In addition, most foundations tend to offer additional advice and support like Ashoka that provides SEs with a worldwide support network of partnerships, peer organisations, and professional consultants or the Avina foundation that provides strategic advice and links social leaders and entrepreneurs across Latin America. SITAWI provides loans to social sector agents at interest rates of about 1% per month being well below market rates. Obtaining a social loan from SITAWI further renders the recipient eligible for the fund’s advisory service. Although the strategic support might occur on a smaller scale than in foundations, it contributes to the professionalization of the fund’s clients.

The ultimate goal of the fund is to contribute to the creation of an infrastructure of financial services for the third sector in Braziland increase the variety and amount of available resources. Therefore, the fund is currently expanding its product portfolio (see section 7.2.1).

7.2.SITAWI'ssocial loans

So far, SITAWI has provided social loans to nine clients, with five clients operating in São Paulo and the rest being dispersed across the nation. An overview of all clients, Caspiedade (Centro de Assistência Social Nossa Senhora da Piedade), Solidarium, Instituto Palmas, Tekoha, ICCC (*Instituição Comunitária de Crédito Central*) Imembuí Microfinanzas, Davida, IDIS (*Instituto para o Desenvolvimento do Investimento Social*), Instituto Feira Preta andCIES (*Centro de Integração de Educação e Saúde*), is provided in annex 10.2.

The following section describesthe structuring of SITAWI's operations in terms of financial products used, the approach to assess the applicant's social impact and default risk, thecontractual provisionsapplied as well as SITAWI's screening and monitoring behaviour. This analysis will facilitate answering the question whether the agency risk explains the practices and the contractual design of financing agreements between SITAWI and its clients.

7.2.1. Portfolio of financial products

SITAWI's major financial product is its social loan with interest below market rates (see section 7.1.4).The management of SITAWI generally rules out offering grants to any organisation and loans are not forgiven under any circumstances.

The fund is working on further expanding its product portfolio. In 2011, SITAWI started a new social fund management vehicle. Through this vehicle, SITAWI acts as an intermediary for companies, families, or organisations that wish to provide loans or grant funds to agents in the social sector. SITAWI controls the cash flow of these clients' funds and provides advisory services. About one quarter of the fund's AUM are managed under this financial service. In 2012, SITAWI further tries to promote inter-sector collaboration through setting up a fund supporting non-profit mergers. A mobile giving fund is further planned.[19]The fees charged by SITAWI for the provision of these financial services are ultimately reinvested in the fund in order to enhance its own operational structure.

[19] Further details on the new funds are deliberately omitted, as the case study analysis focuses on existing financing products.

7.2.2. Social impact and default risk assessment

The in-depth assessment of the eligibility of potential borrowers starts with the filling in of SITAWI's social loan interest form[20]. This form serves as an initial indicator on the applicant's (i) organisational structure, (ii) organisational history, (iii) budget and operations, as well as its (iv) financing needs. SITAWI focuses especially on the three latter issues.

The fund assesses whether the applicant's organisational mission and vision are in line with SITAWI's philosophy, and howand to whom the applicant creates economic value while generating social and/or environmental impact. The loan applicants are asked to provide a summary of past achievements of their operations. As any insights gained by SITAWIare based on the information provided by the applicant, the fund asks for the provision of quantitative and corroborating data as well as public awards and official recognition documentary, whenever possible.

Any applicant is further required to provide information on the organisation's total annual budget, its evolution in the last three years as well as the breakdown of financial expenses and resources. This information should be formally backed up by the provision of the organisation's *Demonstrativos de Resultado* (DRE), the annual results. Concerning its operations, future borrowers are expected to detail their operating model (business and product lines, products, services, target clients/addressees etc.) and how income is created.

When considering the financial health of the applicant, first, the social fund requires detailed information on whether and if so, under which conditions (amount, interest rates, pay-back period) loans have already been provided to the organisation in the past. It is further checked whether the organisation currently has any liabilities (including loans from founders or counsellors). Then, the applicant needs to present a business plan in order to outline for which purpose the loan will be used and in which way it is supposed to contribute in enhancing the organisation's sustainability or in creating social and/or environmental impact. In this respect, the applicant is supposed to estimate the loan's value creation potential in financial and social terms.

The information provided through this initial request serves as a first assessment of the applicant's credit line eligibility. In this step, about 80% of the applying organisations are already sorted out, because what most of them actually need are not loans but donations,

[20] Available on SITAWI's official website: http://www.SITAWI.net/formulario/SocialLoanForm.doc.

explainedSITAWI's CEO Leonardo Letelier. After having passed this initial screening process, loan eligibility depends on the five criteria listed above, (i) creation of social/environmental impact, (ii) ethical fibre of the management, (iii) financial and managerial strength, (iv) structured and convincing business idea, and (iv) willingness to incorporate advice (see section 6.1.3).Leonardo Letelier underlined that the financial sustainability of the applying organisation is a key factor: "If there was any risk of future debt restructuring due to problems in paying back the loan, the applicant immediately disqualifies for the social loan."Thus, before offering a loan, SITAWI thoroughly assesses each applicant's suitability by using the range of the five key criteria just outlined.[21]

7.2.3. Contractual provisions

SITAWI generally uses a standardised contract for its clients, the *contrato de mútuo e outras avenças*[22]. The contractual provisions are the same for any organisationthat has qualified for the loan. The contract is then only individualised in terms of the amount of money lent and the payback schedule.

7.2.3.1.General provisions

Each client's individualised paybackschedule includes a list of all instalments (including interest payments, expenses incurred for the evaluation of the organisation prior to offering the social loanand any applicable tax and further expenses)that are to be made by the borrower. The interest rate applied is 1.0% per month calculated *pro rata temporis* of the days from the date of the disbursement until its effective payment. Interests are calculated based on eachperiod's respective instalment and are due at the same time as the principal. Paragraph 1.6 further protects the fund from incurring any other expenses after closing the contract as those eventual costs are to be entirely born by the borrower.

The contract is flexible in the sense that the borrower, according to paragraph 1.7, has the right to anticipate, partially or entirely, the reimbursement of the loan with a prior notice to the fund of 10 days.

In case of non-payment, according to paragraph 1.8 ff., the borrower will be automatically classified as being in arrears independent of any judicial or non-judicial notification. The organisation will then be confronted with the onus of its default and obliged to pay the fund

[21] Any references to the loan contract are directly taken from a template contract of SITAWI.
[22] Loan contract and further agreements.

the amount originally due increased by (i) a non-compensatory fine of contractual nature of 2.0% on the amount overdue and not paid as previously agreed upon. The borrower will furthermore be obliged to (ii) pay back the principal and any additional attributable expenses including the interest expenses of 1% per month calculated on *a pro rata temporis* base.

Paragraph 1.12 further formally records the integrity of its clients by demanding to guarantee that they have had never in the past, and will never in the future (i) contract child labour or (ii) practice any kind of discrimination. SITAWI's clients are further obliged to (iii) actively contribute to the preservation of the environment and (iv) provide a safe and trustworthy working environment. The fund further prescribes its clients to only enter into service relationships and contractual agreements with third party agents whose practices are in line with the criteria (i) - (iv).

In respect to the debt service payment, according to paragraph 6.2, clause (xvi), SITAWI has seniority of payment over the assets of the backed organisations.

SITAWI, according to paragraph 9, also attributes itself the right of any indemnity by the borrower if the latter causes any loss, harm, or expense to the fund, which is directly linked to the loan agreement.

7.2.3.2.Collaterals

The contract designed by SITAWI offers five different forms of collaterals which the backed organisations are free to provide: (i) a guarantee, (ii) a promissory note (usually provided by the active head of the organisation), (iii) a pawn, (iv) a mortgage, (v) or any other collateral.

In contrast to commercial banks, collateral is not a binding condition for getting a loan from SITAWI."*Se tiver, eu quero. Se não, não é um impedimento*,"[23] explained the fund's CEO. The amount of money lent to the applicant might increase with the provision of a loan, though.So far, a promissory note has been provided by all of SITAWI's clients. Other forms of collateral have not been applied so far.

7.2.3.3.Provisions against hold-up, moral hazard, and adverse selection

In paragraph 5 SITAWI presents nine criteria for which the fundhas the right to bring forward the expiration date of all the liabilities assumed by the backed organisation and to end the

[23] If there is one, I want it. If there is not, it is not a hindrance, either.

provision of the consulting services (as defined in paragraph 2) with all liabilities being to be paid back by the borrowerimmediately and in total including any applicable charges and expenses. In the underlying analysis, especially the three clauses (i, ii and viii) are of relevance in terms of moral hazard. Through these provisions, SITAWI protects its assets from (i) any non-compliance or violation on the part of the backed organisationof the terms mutually agreed upon. Also does SITAWI withdraw its funds (ii) if the backed organisation uses the resources provided for any purpose different from the one agreed upon in paragraph 4 and (viii) in case the contract was made under false assumptions based on falsified documents or incomplete and/or false information provided by the borrower at the time of signing the contract. Further provisions equally protect SITAWI in case of significant default risks (self-declared or pointed out be the borrower's financial institution), judicial prosecution of the borrower, insolvency or liquidation of the organisation, a change in the control of the governance, and the alienation of goods.

Paragraph 6 further demands the borrower to inform the fund in case of the existence of a conflict of interest between both parties (clause (xii)).

7.2.4. Monitoring of clients

The contract between SITAWI and its borrower does not prescribe any frequency of interaction between both parties. It mainly focuses on financial objectives, especially concerning the repaymentschedule and the borrower's default risk. In paragraph 6 of the loan agreement,the obligations of the borrower are specified. SITAWI has the right to demand any information necessary for the succession of providing their financial and advisory services to the backed organisation. This information focuses on accounting, governance and control issues, but is not restricted to this information. The fund generally has the right to demand, and the borrower the obligation to provide, without any delay, any information necessary for monitoring the risk in terms of the borrower's default or any action or event outlined in paragraph 5 (see section 6.2.3.3).

No monitoring in terms of whether the backed organisation achieves its objectives of generating social impact occurs. The reasoning for this is threefold. First, the assessment whether the borrower's organisation actually has a "direct and relevant contribution in solving a social or environmental challenge" (http://www.sitawi.net/) is part of the screening process when checking for the applicants' credit line eligibility. Second, no clear-cut definition of

social impact itself exists and there is no standardised approach of measuring it. Furthermore Leonardo Letelier explained that any social impact that might have been generated by using the loan could not be completely attributed to SITAWI itself. The merging of multiple factors like the borrowers' own resources with the loan ultimately contributes to the creation of social impact. In the contract, in paragraph 6 clause (xv), the backed organisation is merely taught to use the resources provided by SITAWI for the goals mutually agreed upon and fixed in the contract. The ultimate outcome of this use is not relevant within the contract.

Still, each contract prescribes in which way, for which ultimate goal, and through which activities the resources provided through the social loan are to be used. Paragraph 4 of the contract is meant to assure that the social loan will only be used as means in order to achieve these predefined goals.

After closing the contract, interaction between both parties takes basically place through the advisory activity of the fund. SITAWI identifies key questions and problems of the backed organisation and provides strategic advice on those issues and also offers a service of technical assistance. This interaction is formally defined in paragraph 2 of the contract. The backed organisation is expected to accept the support of SITAWI in relevant social, operational and financial key questions. The assistance usually tackles administrative aspects, projects, business plans, and strategies pursued by the borrower. Still, SITAWIhas the right to interact in any form in the control, administration, and realisation of its clients business which do not directly relate to both parties' mutual agreement. In order to translate this condition into practice, both parties oblige themselves to hold meetings according to the schedule mutually agreed upon. In addition, the backed organisation is expected to provide SITAWI with any documents needed including financial statements, societal acts and contracts signed by the borrower. Although formally prescribed through the contract, this interaction remains punctual, primarily focussing on key events and milestones in the organisation's development. "Interaction with SITAWI's clients should ideally take place once a month. This is the *should be*, though. It is actually never the case." stated Leonardo Letelier. The fund's CEO further explained that there is no need for a contractual provision of such interaction. If there was a need for establishing this interaction in the contract, this would demonstrate that the cooperation was actually not feasible or at least not worth taking place. According to Leonardo Letelier, cooperation and interaction should and do take place naturally if the backed organisation is correctly chosen.

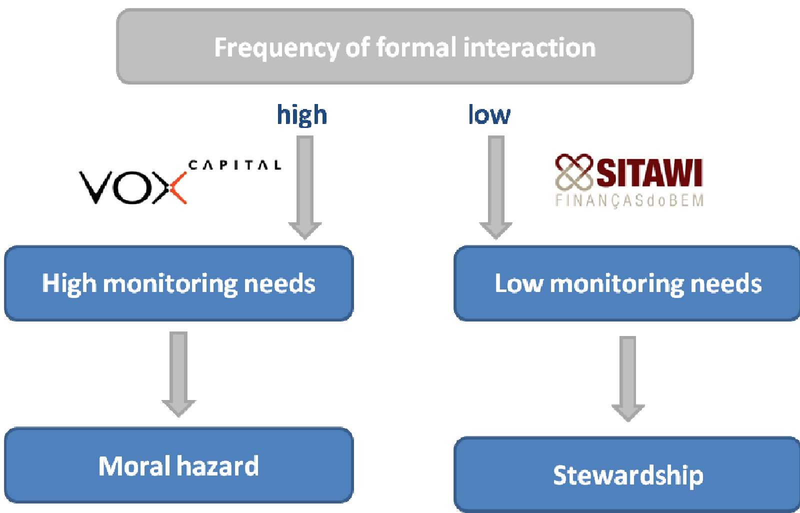
8. Discussion of Results

8.1.Discussion of research propositions

Any of the this study's four propositions uses the perception of either moral hazard or stewardship within the underlying cooperative structures as starting point for further deductions. In line with the reasoning of Fama and Jensen (1983), frequent formal interaction suggests the need for intensive monitoring and thus a high perception of moral hazard. *Argumentum e contrario*, low frequency of interaction implies stewardship as adequate framework to describe the relationship between funding entity and funding recipient.

In the case of Vox Capital, formal interaction is frequent according to this study's definition as it takes place on a *monthly* basis. Perception of moral hazard is thus perceived to be high. For SITAWI in contrast, interaction is found not to be frequent. Interaction is need- and event-driven without its frequency being contractually fixed. Interaction on a monthly basis is regarded as desirable but unrealistic. This implies stewardship as underlying relationship. The flow-chart in figure 9 summarises the findings in regard to the cases' frequency of formal interaction and its implications for the incidence of moral hazard and stewardship.

Figure 9: Findings for frequency of formal interaction and implications



Source: The author.

Based on these findings, the four research proposition will be discussed in the following section. As both funds are different in their perception of moral hazard, any proposition only directly applies to one of the cases, respectively: RP1 and RP4 to SITAWI, and RP2 and RP3 to Vox Capital. The argument of each research proposition itself as well as the inversion of the argument will be analysed in order to be able to draw conclusions on both cases.

8.1.1. Proposition 1: No grants, but a theory of change

Proposition 1 suggests that *the lower the perception of moral hazard by the funding entity of inclusive businesses, the higher the use of grant financing*.

As presented in the case analysis, neither Vox Capital nor SITAWI use grants as financing instrument for funding social enterprises or mission-driven organisations, respectively. In their empirical study, Alemany and Scarlata's (2010) findings depicted a "significant negative correlation between grant financing and the frequency of formal meetings" (p.135) and concluded that stewardship, rather than moral hazard, would be suitable to explain the deal structuring behaviour of Philanthropic VCs in Europe and North America. Does thegeneral absence of grants as financing instrument *argumentum e contrario* imply a non-alignment of interests between funder and funding recipient in this study's underlying cases? The reasoning for deducing proposition 1 was that grants best met the funding needs for the backed organisations. Funding entities concerned with best meeting the needs of those organisations would thus use grants as means of financing. The logic underlying the business model of Vox Capital and SITAWI is different though. Vox Capital deliberately chose the legal structure of a for-profit organisation, because of the fund's *theory of change* (see section 6.1.2). For the same reason, the fund does not offer grants but uses financial instruments traditionally applied in the corporate sector, namely equity and convertible debt. Vox Capital's clients are exclusively for-profit and the formal interaction is frequent. SITAWI also applies financial instruments from the corporate sector in order to address the financing needs of the social sector and unambiguously confirms that is does not make grants or forgive its loans. But in contrast to Vox Capital, apart from the SEs *Tekoha* and *Solidarium*, SITAWI's clients are all not-for-profitorganisations.

In the underlying cases, the choice of the financing instruments is revealed to be independent from the monitoring needs of the funding entities. Rather than causally linking the financing instruments to the frequency of interaction,in this study, the legal structure of the funding recipients is found to be an indicator for the frequency of interaction. Proposition 1 was adapted from a study conducted on PhVC in North America and Europe and the analysis suggests that the proposition does not apply to the Brazilian market.

8.1.2. Proposition 2:Application of industry practicesfrom the corporate sector

According to proposition 2, *the higher the perception of moral hazard by the funding entity of inclusive businesses, the higher the use of valuation and default risk assessment models.*

In the case of Vox Capital, the valuation of the for-profit venture comprehends a twofold assessment analysing the venture's social impact in qualitative (generation of systemic change) and quantitative (number of people served) terms as well as the value of the business model. For the latter, Vox Capital reported to apply criteria in line with the VC industry standard as found by Tyebjee and Bruno (1984) and MacMillan et al. (1987).Still, one additional and particular criterion is applied by the fund; a qualitative assessment of the venture's "fit" to Vox Capital.The fund assesses the applicant's actual needs and whether it is able to support the venture in overcoming eventual problems and to respond to its needs. In this regard, the investor acts rather as a steward than as a principal. Still, although this implies a steward rather than a principal-agent relationship, this last criterion is embedded within a set of further criteria and does not substitute the application of a formal company valuation model common to the traditional VC market. When considering the investment in Vox Labs, the ventures are generally in a too early stage to conduct a company valuation. Instead, the investment-decision is rather based on the potential of the applicant's business idea and whether Vox Capital can contribute to its structuring and development. These considerations are in line with the last criterion applied by Vox Capital, and again imply a stewardship, rather than a principal-agent relationship. Despite these indications of steward behaviour,once becoming eligible for the status of a Vox investment, the Vox Labs also become subject to the same evaluation criteria as companies in the traditional VC market following a rigorous assessment. Thus, although stewardship might characterise the first phase of the cooperative structure, the model cannot entirely describe the principal-agent relationship once an equity investment is made. Given the research findings, albeit alleviated through Vox Capital last formal valuation criterion, trust or specific needs valuation do not supersede traditional valuation models.For investments in for-profitSEs,Vox Capital refers to traditional enterprise valuation models.Since the incidence of moral hazard has been found to be subject to the business model of Vox Capital and the inversion of proposition 2 suggests that moral hazard explains the use of traditional valuation models, the second proposition is supported in the case of Vox Capital.

In the case of SITAWI, a sequential assessment of the loan applicant's eligibility in two steps is conducted. For loan aspirants passing the first screening, a rigorous assessment of the organisation's creditworthiness follows. Financial statements and additional accounting data are used to gain insights in the organisation's financial health. The variables used in the assessment coincide with those commonly applied in the banking sector as found McNamara and Bromiley (1997).SITAWI also asks for corroborating data, and ideally third-party indications as external independent information so as to reduce the risk of adverse selection. Thus, a rigorous default risk assessment is applied by SITAWI, although the funding entity was found to rather act as a steward than as a principal. This contradicts the second proposition.

Given this finding, further implications of the proposition should be considered. Despite the indication of frequency of formal interaction suggesting stewardship in the SITAWI case, it should be considered that this proxy is based on a study focusing on manifestations of the venture capital model. A VC investment traditionally requires more interaction with its portfolio companies than does loan financing.

Inversing the argument of proposition 2, the question whether a higher use of default risk assessment models implies moral hazard in the case of SITAWI, should be considered. Two arguments contradict this conclusion. First, the default risk assessment is supposed to set the "price" of the loan contract through defining the loan's interest rate. Still, in SITAWI's business model, the interest rates are fixed and significantly below the interest charged in Brazil's banking sector, *ceteris paribus*. Second, the *Caspiedade* case has shown that instead of following *de iure* implications and fining an organisationthat faces problems in honouring its debt, SITAWIcarefully weighs every case and its circumstances and actively supports the organisation to surmount its financial problems. In response to delayed payments, the advisory activity was increased and the loan contract restructured. Additionally, in case of early payments, the loan recipients receive discounts. This support manifestly differentiates SITAWI from a traditional bank and proves its role as a steward. Thus, although the contractual design of the cooperative structure would rather suggest an agency problem constellation, it can be concluded that stewardship qualifies the relationship between SITAWI and its clients,*ceteris paribus*. Building the financial infrastructure of the social sector in Brazil rather than maximising profits is the premise underlying SITAWI's business model.

8.1.3. Proposition 3: Market-standard oriented contractual provisions

Proposition 3 suggests that,*the higher the perception of moral hazard by the funding entity of inclusive businesses, the higher the use of binding contractual provisions.*

Vox Capital uses three contracts to govern its investments. The contractregulating the cooperation among the shareholders, *o acordo entre acionistas*, conforms to the industry standards of the corporate sector, where contracts aremarkedly similar across countries and legal systems (Chemla et al., 2007). Key paragraphs that are commonly found in traditional shareholder agreements also govern Vox Capital's investments. The case study discussion revealed that the fund uses a clause to protect against the risk of hold-up through a non-compete clause. Although no vesting provision is used, its introduction in future contracts is envisaged. Considering controlling and renegotiation clauses, Vox Capital's shareholder agreement also follows the industry standards including all major provisions except the anti-dilution clause. This presence of elaborate governance structures and contractual provisions is in line with the findings of high perceived moral hazard. Proposition 3 is thus supported in the case of Vox Capital.

SITAWI's contract was designed by external lawyers andthe contractual provisions reflect key elements commonly applied in the traditional credit market. The contract comprises a myriad of provisions including seniority of payments and an insurance of the lender in case of non-payment which prescribes an according onus for the defaulting party. The contract also envisions five different potential types of collateral. The maturity is individually set for every loan applicant, but maturities are short, with the maximum duration of a contract having been 30 months. Additionally, SITAWI contractually insures its assets against the risk of moral hazard, hold-up, and adverse selection (section 7.2.3.3: paragraph 5, clause i, ii, and viii, respectively). While the frequency of interaction implied stewardship instead of moral hazard as framework to qualify the underlying funding relationship, contractual provisions are designed so as to insure the funding entity against any incidence of the agency problem. All of these findings indicate that proposition 3 cannot be sustained in the case of SITAWI.

Considering the discussion of proposition 2, analogously, the inversion of the argument should be checked for. Does the extensive use of covenants imply a perception of moral hazard by SITAWI? In line with the previous reasoning, one additional argument to answer in the negative has been found. Although SITAWI openly formulates its preference for clients providing collateral, it is not a binding condition for granting a loan. This markedly contrasts

the Brazilian banking standard where the provision of collateral is mandatory.Not supporting both propositions in the case of SITAWI thus implies that pre-loan concession, the agency risk explains practices and contractual structuring of the funding entity. Post-loan concession, stewardship adequately describes the actual funding relationship. This finding underlines the deliberate strategic choice of SITAWI to apply models from the traditional corporate sector and transfer them to the social sector.

8.1.4. Proposition 4: Precedence of trust does not substitute contractual provisions

According to proposition 4, *the higher the stewardship offered by the funding entity of inclusive businesses, the higher the importance of trust vs. formal contractual provisions.*

The previous discussion of proposition 1 revealed, that moral hazard explains the funding relationship between Vox Capital and its portfolio companies, whereas stewardship adequately describes the one between SITAWI and its clients. The findings from proposition 3 can further be applied to the discussion of the last proposition. Despite SITAWI’s elaborate contractual agreements, trust among the fund and its clients has been found to be of crucial importance. Interaction takes mainly place in form of the fund’s advisory activity and its frequency is not contractually fixed. According to the fund’s philosophy, being obliged to rely on contracts to effectively and efficiently interact with its clients would imply that the cooperation as such was not worthwhile taking place. SITAWI’s selection process is supposed to filter its clients so as to assure that the interests of both parties are aligned. The last proposition is thereforesupported in the case of SITAWI.

In the case of Vox Capital, stewardship could not adequately describe the funding relationship. This implies that contractual provisions have precedence over trust governing the funding relationship, which is true for Vox Capital. In line with proposition 3, proposition 4 is then also supported for Vox Capital.

Table 4: Summary of findings from research proposition analysis

Research Proposition	Finding		Rationale[24]
RP1:*The lower the perception of moral hazard by the funding entity of inclusive businesses, the higher the use of* ***grant financing***	VOX	✗	No grants, but a *theory of change*.
		✗	RP does not apply to Brazilian market.
RP2: The higher the perception of moral hazard by thefunding entity of inclusive businesses, the higher the use of ***valuation and default risk assessment models****.*	VOX	✓	Stewardship pre-equity investment, needs' assessment does not substitute formal criteria of investment decision.
		✗	Rigorous default risk assessment despite steward behaviour, fixed interest rate and Caspiedade case reinforce stewardship finding.
RP3: *The higher the perception of moral hazard by thefunding entity of inclusive businesses, the higher the use of* ***binding contractual provisions****.*	VOX	✓	Presence of elaborate governance structures and contractual provisions.
		✗	Extensive use of covenants, but collateral not a binding condition; Insurance against agency risk pre-loan concession, stewardship post-loan concession.
RP4*: The higher the stewardship offered by the funding entity of inclusive businesses, the higher the importance of* ***trust vs. formal contractual provisions.***	VOX	✓	Covenants have precedence over trust governing the funding relationship.
		✓	Client screening pre-loan concession assures alignment of interests and thus facilitates trust post-loan concession.

✗ RP is not supported, ✓ RP is supported

Source: The author.

[24] Rationale building on findings for of moral hazard and stewardship, respectively. See figure 9.

8.2.Conclusion

The objective of this research was to answer*whether the agency risk explains the practices and the contractual design of agreements employed by entities financing social sector activity in Brazil* through the analysis of a set of four research propositions. While the first proposition was found not to apply and the fourth one was supported, proposition 3 and 4 were only found to be true in the case of Vox Capital (see Table 4).

Althoughproposition 1was supported in neither case,*argumentum e contrario* the absence of grants as financing instruments does neither imply moral hazard nor a non alignment of interest. The contrary is found to be true in the Brazilian market.Through the deliberate choice of financing instruments that reflect the common practices of the corporate sector while offering professional advice, the funding entities expect the financially backed organisations to enhance their own business model and internal operations. Confronting the mission-driven agents with the realities of the market and its obstacles in terms of financing might trigger the professionalization of these organisations and support them to eventually become more efficient. For Vox Capital, this is in line with its *theory of change* suggesting that by professionalising Brazil's social sector, the capital inflow will be spurred, which again, will help to scale up social enterprises and their impact. SITAWI's business model follows the same logic: Through the access to capital and the obligation to honour their debt, mission-driven organisations in Brazil are obliged to better structure their cash-flow management and render their internal operations more efficient so as to better manage their costs and expenses. Another conclusion from proposition 1 was that, rather than causally linking the choice of the financing instruments to the frequency of interaction, the legal structure of the funding recipients has been found to be an indicator for the frequency of interaction.This indicates that the non-distribution constraint of the portfolio companies is an indicator for moral hazard, as interaction will be lower when the non-distribution constraint applies. Therefore proposition 1 is found not to apply to the Brazilian market. This underlines the differences between financing models of SEs and NFPs in Brazil, and North America and Europe.

The second, third, and fourth proposition have all been found to be true for Vox Capital. This suggests that moral hazard explains the VC's practices and the contractual design of agreements. Given the forgone reasoning (8.1.2 and 8.1.3.), although the second proposition was not supported in the case of SITAWI, it is concluded, that pre-loan concession, moral hazard and hidden characteristics describe the cooperative structure between the funding

entity and the fund applicant. Post-loan concession, stewardship adequately describes the funding relationship ofSITAWI with its loan recipients. The concession of a loan is found to be an indicator of trust triggering the stewardship behaviour. This conclusion is equally in line with proposition 4, which has been supported in the case of SITAWI.

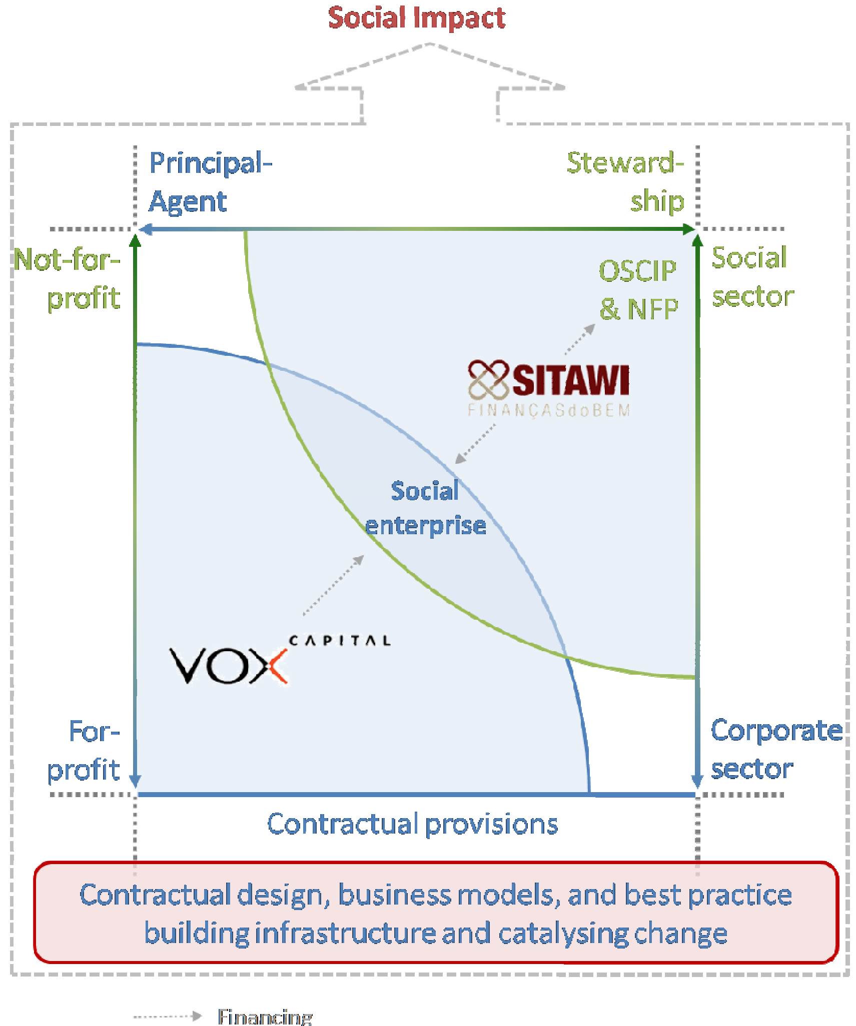
The findings from this research only in part correspond to those of the study of Alemany and Scarlata (2010), which was used as a framework for this multiple case-study. Covenants were found not only to mitigate the agency risk resulting from the absence of the non-distribution constraint (Alemany &Scarlata, 2010), but also to govern cooperative structures with not-for-profit entities, that is, in the presence of a non-distribution constraint.Another particularity of the market was that, although the non-distribution constraint of SITAWI's clients has proven to be an effective tool in order to align the interests between fund provider and the financially backed organisations, the precedence of a stewardship relationship did not rule out the application of contract features commonly used to reduce the agency risk. When no non-distribution constraint applied, in the case of Vox Capital, the covenants and valuation models accounted for any potential agency risk and thus reflected practices commonly applied in the corporate sector. Thus, while research for Europe and North America suggests that stewardship explains the deal structuring of innovative funding models financing social sector activity, this case study's results suggest different findings. The business modelsof Vox Capital and SITAWI, which have recently entered the Brazilian market, are conceptualised in a different way and with a distinct underlying understanding of the role of agents in the social sector than the model of Philanthropic VC in Europe and North America. Financing agreements are structured in a way to account for and mitigate any potential incidence of the agency risk and therefore reflect market realities from the second sector. This finding suggests that the agency risk explains the practices and the contractual design of agreements employed by entities financing social sector activity in Brazil.

Vox Capital uses a VC fund model and the practices it applies reflect the industry standard of the sector. Implications of the agency risk for VC model will thus hold for Vox Capital as well. What makes the fund particular and of significant value for the Brazilian market is that it applies a business model from the traditional corporate sector in order to achieve social impact. Through this approach, agents from the social sector are induced to adapt their business model and migrate into the corporate sector.SITAWI on the other hand acts as a steward when servicing its clientswhile applying the default risk models and contractual provisions common to the traditional banking sector. It thus replicates business models and

approaches from the corporate sector in order to build a corresponding infrastructure in the social sector. The framework initially suggested needs to be adapted according to these findings as illustrated in figure 10.

It is conclude that Vox Capital makes the social sector enter the corporate one, while SITAWI is a business model inspired by the corporate sector and acting in the social one. Both business models are complementary and mutually enforcing each other in order to enhance the activity of inclusive businesses in Brazil and thus contribute to the creation of social impact through building infrastructure and catalysing change.

Figure 10: Social impact generation: Cross-sector application of best practice models



Source: The author.

8.3.Limitations of research findings and conclusion

This study's findings need to be considered with caution, as the immaturity of the market has two important implications that need to be accounted for when interpreting this study.

First, the number of agents that adapt business models from the corporate sector to provide access to capital to the SEs and the social sector is low. This significantly limited the size of the sample for the underlying research and implied the use of a case study method instead of empirical testing. This limits the external validity and the generalisability of the findings.

Second, the low number of agents for adequately conducting the research further resulted in a sample of two funds using a fundamentally different business model. Vox Capital applies the business model of a venture capital fund in the traditional sense while SITAWI is a fund functioning as a hybrid between a bank and a foundation. Although the two agents were deliberately chosen in accordance with the reasoning previously outlined (see section 4.2), the differences in the funding entities' business modelshave implications for the presence of moral hazard and stewardship. The underlying assumption is that the frequency of interaction can be used as a proxy for monitoring needs and thus the perception of moral hazard by the funding entity. However, the frequency of interaction can also be causally linked to each funding entity's business model, because venture capital investments generally require more interaction than loan financing. The reason for choosing frequency of interaction as a proxy was to account for internal validity through adapting an existing research framework to the present research.

It further needs to be taken into consideration, that the conclusion drawn for the actors in the social sector is not generalisable, as not anyorganisational model or practice from the corporate sector is transferable to the social sector and *vice versa*. Social enterprises might be able to bridge some gaps between the social and the corporate sector. Still, those organisations need to be understood as complements to the agents traditionally working in the third sector,and not as substitutes.

8.4.Implications for practitioners and further research suggestions

Based on these findings, practitioners in both, the corporate and the social sector can draw conclusions in terms of governance and contractual structuring when aiming for social (and environmental) impact generation. The main implication of this work is that the application of business models and practices from the traditional business to the social sector might ultimately contribute to the latter's development and professionalization.

For academics, four paths of future research to better understand Brazil's social sector and its agents are suggested: First, quantitative research in the Brazilian market in order to substantiate the findings from these two case studies will be necessary. However, given the premature nature of this market, an empirical testing of the incidence of the agency problem in the market for social enterprises and mission-driven organisations is a long-term objective, though.Second, this research mainly focuses on the incidence of moral hazard. A more thorough analysis of the hold-up and the adverse selection problem in inclusive businesses would contribute to the understanding of the funding structures in the market. Furthermore, in this case study, merely two business models for financing social sector activity have been analysed, VCs and funds. A qualitative analysis of further business models, like institutions conceding micro-credits to actors in Brazil's third sector is thus suggested. Lastly, this study was mainly concerned with the challenge of financing social sector activity and SEs. But, given the immaturity of the market, some research analysing strategic, managerial, or cost-efficiency aspects of the agents' business model would alsobe of interest for scholars and practitioners, as it would provide them with a helpful reference to succeed in a newly emerging and promising market.

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10. Annex

10.1. Profile of Vox Capital portfolio investments [25]

Name	Location	Investment structure	Investedin	Activity
PLANO cde	São Paulo, SP	Equity	mid 2009	**Market intelligence and consulting** firm processing information about markets and people in the socio-economic classes C, D, and E in Brazil and offering market research, consulting and training to actors in the market in order to leverage their business potential.
balcão de empregos.com a sua melhor colocação no mercado	São João da Boa Vista, SP	Equity	mid 2011	**Job placement** company offering operational and technical job opportunities through the provision of access to market information on employment opportunities for Brazil's low-income population. Balcão de emprego currently offers about 60,000 job opportunities.
Minha Casa Minha Vida	Brasília, GO[26]	Equity (investment in project, not a company)	late 2011	**Large scale housing project** of the Brazilian government providing housing opportunities for low-income families. [27] Vox Capital participated as co-investor with Bamboo Finance (a Swiss impact investor) to contribute to the creation of 1,300 houses. This participation, referred to as "Vox Minha Casa", is particular as it is a short-term project investment with the construction company*Crinale*

[25] CDI Lan, Sautíl and Banco Pérola are Vox Labs.
[26] Project initiated by the Brazilian government (sitting in Brasília), but operationally administered from federal states across Brazil.
[27] Up to 10 minimum salaries (R$ 5.450).

				*Incorporadora*being operationally responsible.
CDI LAN www.cdi.org.br	Rio de Janeiro, RJ	Convertible debt	May 2010	CDI develops a **distribution** network through the use of internet cafes across Brazil and offers **financial and e-learning services**.
Banco Pérola	Sorocaba, SP	Convertible debt	Nov 2011	**Microcredit** organisation offering financial services to young entrepreneurs in remote locations where access to infrastructure and capital is scarce.
SAÚTIL.COM.BR	Goiânia, GO	Convertible debt, currently DD for equity investment	Nov 2011	Internet platform processing **information about public health care services** and products in order to facilitate the access to those local institutions.

10.2. Client Profile SITAWI

Name	Location	Legal Structure	Description	Loan size [in k R$][28]	Year of loan	Status of repayment
SOLiDARiUM Transforme o seu mundo	Curitiba, PR	SE	A social enterprise of *Aliança Empreendora*, a promoter of small **artisanal associations** through the provision of support and **market access**. Solidarium links local communities to major retailers like Wal Mart, Lojas Renner, and Tik and Stok contributing to a more stable income generation and sustainability of the associations' businesses.	150	2008	Fully repaid on time.
Davida PROSTITUIÇÃO, DIREITOS CIVIS, SAÚDE	Rio de Janeiro, RJ	NFP	**Clothing** brand launched in 2005 and owned by Davida, an association fighting for the **rights**, mobilization and social control of **prostitutes** in RJ. Davida educates prostitutes and clients in the prevention of STD and HIV-AIDS. Daspu serves as income generator	45	2008	Fully repaid on time.
Tekoha	São Paulo, SP	SE	**Fair marketing** coalition for handmade and artisanal products from Brazil. Tekoha links the communities to its products consumers while providing transparency on the cost along the value chain in order to assure that about	100	2009	Fully repaid on time.

[28] Rounded values.

			50% of the generated income remains with the producers.			
	São Paulo, SP	NFP[29]	**Social service** agency contributing to the development of socially vulnerable communities in SP through socio-educational and vocational assistance, provision of food aid, assistance and social inclusion.	200 300	2009 2010	First loan fully repaid, second loan currently being restructured.
	Fortaleza, CE	OSCIP	*Conjunto Palmeiro*, a community operating under the principle of the **"Solidarity Socio-Economy"** since the 1970s, founded the institute Palmas to fight poverty and promote empowerment of vulnerable communities in the Northeast of Brasil through the promotion and coordination of socio-economic business model generating income and social inclusion. Within this organisation, Banco Palmas was designed in order to provide **micro-credits**, technical support, entrepreneurial training, and to promote joint partnerships.	150 75	2009 2010	Fully repaid on time.
	São Paulo, SP	OSCIP	Promotion of social development and reduction of social inequalities within Brazil through designing business model for social intervention.	140	2010	Fully repaid on time.

[29] NGO without official OSCIP status.

	São Paulo, SP	NFP	The not-for-profit Instituto Feira Preta promotes the socio-cultural development of the black community in Brazil through the implementation and coordination of qualification activities, events, exhibitions and courses. It further supports Brazilian African entrepreneurs on a national level.	100	2011	Fully repaid on time.
	São Paulo, SP	NFP	The project CIES has been designed in order to provide the population with a mobile medical health care system and to detect and fight the most prominent diseases in Brazil through the CIES MOVEL, a specially designed cart fulfilling the role of a small hospital where minor surgeries can take place.	200	2011	On time with scheduled payment.
	Santa Maria, RS	NFP	The NGO Imembuí Microfinanzas (ICCC) provides **micro-credits** to small entrepreneurs who do not have access to capital in the traditional banking sector.	400	2011	Fully repaid ahead of schedule.

10.3. Interview questions with SITAWI and Vox Capital – Comparability of funders

<table>
<tr><td rowspan="4">Comparability of funders in terms of</td><td>Age</td><td colspan="2">When has your fund been launched?

After launching, when did you become operational?</td></tr>
<tr><td rowspan="2">Stage of developement</td><td colspan="2">How many financing rounds did you have so far? Planning to further raise funds? Is the next financing round already scheduled?

Who are your funders? (Private, institutions, foundations, corporations...)</td></tr>
<tr><td>Do you or your team members have any previous experience in the lending business? If so, for how long? In which sector?

How many AUM do you currently have? Which proportion of the AUM has already been conceived as loans?

How long is the payback period in general?

Is your fund financed by grants, only?</td><td>Do you or your team members have any previous experience in the VC market? If so, for how long? In which sector?

How many AUM do you currently have? Which proportion of the AUM has already been invested?

How long is the lock-up period of the investment in general?</td></tr>
<tr><td>Location</td><td colspan="2">Where does your fund operate? Only in Brazil? In which states in Brazil?</td></tr>
<tr><td>Differences of funders in</td><td>Legal structure</td><td colspan="2">What is the legal structure of your company?</td></tr>
</table>

terms of		Do you generate profits? If so, are they directly re-injected in the fund?	How do you **distribute your profits**? Only after exits? How are your investors compensated? Which **contractual provisions** do you use?
	Investment/ funding target	What is the **legal structure** of your clients? In which **maturity stage** do you invest? What organizations do you focus on in terms of **impact** generation?	
			In what way do your investments in the **common VOX portfolio** differ from the **VOX Labs**? Could you describe your investment strategy and in which way it differs?

10.4. Interview questions with SITAWI and Vox Capital –Variables for RPs

	SITAWI	Vox Capital
RP1: **Financial instruments**	Beyond loans do you use **further financial instruments** (i.e.banking account overdrafts, promissory note discounts and working capital short-term loans while larger companies rely on export draft discounts or foreign loans or vendor credits)[30]?	Beyond equity and convertible debt, do you use **further financial instruments** (convertible preferred stock, straight (nonconvertible) debt, convertible preferred equity, mixes of common equity and straight debt, and straight preferred equity)[31]?
	Could you explain the choice of these further financing instruments?	
	Why are **grants** no option for you?	
RP2: **Company valuation**	Which criteria do your clients need to fulfil in order to receive a loan: Financial sustainability/ viability: is there any company valuation or test for **creditworthiness** through a financial analysis (of profitability, cash flow, liquidity, leverage, collateral margin and size), consulting of credit agencies, previous creditors, suppliers, and/ or customers?[32] OR is it rather the investment project and its social/ environmental impact which SITAWI focuses on?)	Which approach do you use for **valuing** your company? Do you use the following criteria:. management skills, market size and growth, rate of return, market niche/ position, and financial history, and management experience, basic project viability, exposure to competition and profit erosion, and the risk of locking up the VC's investment?[33] Are different criteria used for the common Vox investments and the Vox Labs?

[30] Types of credit commonly found in Brazil (Leal & Carvalhal da Silva, 2006).
[31] Industry standard in VC market (Cumming, 2005).
[32] Industry standard in banking sector (Ruckes, 2004; McNamara and Bromiley, 1997).
[33] Industry standard in VC market (Tyebjee and Bruno , 1984; MacMillan, Zemann, and Subbaranasimba, 1987).

<table>
<tr><td rowspan="2">RP3:

Contractual agreements and provisions</td><td colspan="2">Are the contracts individualized or do you have a standardized contracts for your clients?

Do you have any binding contractual provisions for your clients?

Are those rights contingent on the performance of the venture? (Do you exert more rights when the venture is performing poorly?)</td></tr>
<tr><td>Do you use any collateral in order to secure the loan?

Which interest rates do you charge? Are they below the market rate?

Has one of your clients already defaulted on paying back the loan? (No, but so far, you have a short history, thus, how many did do far return the loan?)</td><td>Do you have any other contractual provisions (e.g. vesting provisions, control rights, renegotiation clauses like anti-dilution, pre-emption, tag along, drag along)?[34]</td></tr>
<tr><td rowspan="2">RP4: Frequency and kind of interaction</td><td colspan="2">How often do you interact with your clients? (Quarterly, biannually, annually, etc.)

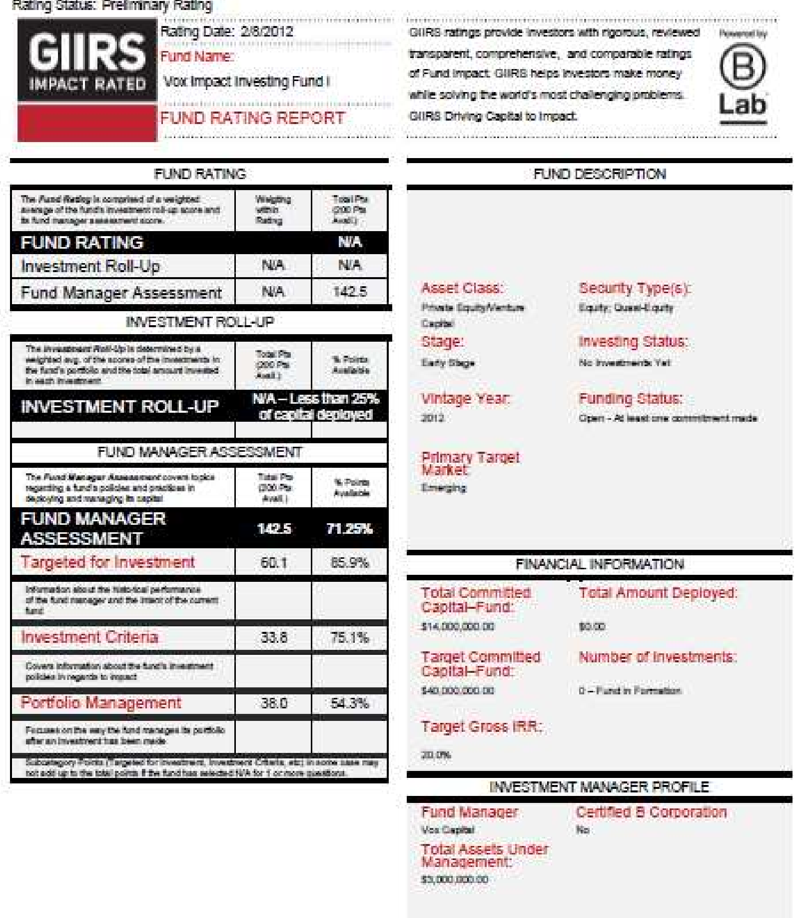
Is the frequency of interaction set through a contract?

Is the interaction for monitoring or rather for consulting reasons?

How do you assess the progress of your company (in financial and in terms of social impact)?</td></tr>
<tr><td>Does the interaction increase if your borrower gets problems on honouring his debt?</td><td>How helpful are the IRISand the GIIRS for assessing the social impact of your portfolio companies?</td></tr>
</table>

[34] Clauses commonly used in shareholder agreements in VC industry (Chemla et al., 2007).

10.5. GIIRS – Rating Vox Impact Investing Fund I



Rating Status: Preliminary Rating

GIIRS IMPACT RATED

Rating Date: 2/8/2012

Fund Name: Vox Impact Investing Fund I

FUND RATING REPORT

GIIRS ratings provide investors with rigorous, reviewed transparent, comprehensive, and comparable ratings of Fund impact. GIIRS helps investors make money while solving the world's most challenging problems. GIIRS Driving Capital to Impact.

Powered by B Lab

FUND RATING

The *Fund Rating* is comprised of a weighted average of the fund's investment roll-up score and its fund manager assessment score.	Weighting within Rating	Total Pts (200 Pts Avail.)
FUND RATING		**N/A**
Investment Roll-Up	N/A	N/A
Fund Manager Assessment	N/A	142.5

INVESTMENT ROLL-UP

The *Investment Roll-Up* is determined by a weighted avg. of the scores of the investments in the fund's portfolio and the total amount invested in each investment.	Total Pts (200 Pts Avail.)	% Points Available
INVESTMENT ROLL-UP	**N/A – Less than 25% of capital deployed**	

FUND MANAGER ASSESSMENT

The *Fund Manager Assessment* covers topics regarding a fund's policies and practices in deploying and managing its capital	Total Pts (200 Pts Avail.)	% Points Available
FUND MANAGER ASSESSMENT	**142.5**	**71.25%**
Targeted for Investment	60.1	85.9%
Information about the historical performance of the fund manager and the impact of the current fund		
Investment Criteria	33.8	75.1%
Covers information about the fund's investment policies in regards to impact		
Portfolio Management	38.0	54.3%
Focuses on the way the fund manages its portfolio after an investment has been made		

Subcategory Points (Targeted for Investment, Investment Criteria, etc) in some case may not add up to the total points if the fund has selected N/A for 1 or more questions.

FUND DESCRIPTION

Asset Class: Private Equity/Venture Capital

Security Type(s): Equity; Quasi-Equity

Stage: Early Stage

Investing Status: No Investments Yet

Vintage Year: 2012

Funding Status: Open - At least one commitment made

Primary Target Market: Emerging

FINANCIAL INFORMATION

Total Committed Capital–Fund: $14,000,000.00

Total Amount Deployed: $0.00

Target Committed Capital–Fund: $40,000,000.00

Number of Investments: 0 – Fund in Formation

Target Gross IRR: 20.0%

INVESTMENT MANAGER PROFILE

Fund Manager: Vox Capital

Certified B Corporation: No

Total Assets Under Management: $3,000,000.00

Rating Status: Preliminary Rating

GIIRS IMPACT RATED

Rating Date: 2/8/2012

Fund Name: Vox Impact Investing Fund I

FUND RATING REPORT

GIIRS ratings provide investors with rigorous, reviewed transparent, comprehensive, and comparable ratings of Fund impact. GIIRS helps investors make money while solving the world's most challenging problems. GIIRS Driving Capital to Impact.

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FUND INCENTIVE STRUCTURE

Management Fee: 2.5%

Incentive Structure Description: Carried interest, after hurdle rate (inflation + 6%), will be based on both financial return and social impact (measured by GIIRS - we'll establish a social hurdle rate with investors). If we don't reach social impact goals, carried will be only 10%.

Hurdle Rate: 6.0%

Investment Term (Years): 10

Target Close: Q1 2012

Target Limited Partners: Bank; Development Finance Institution (DFI); Family Office/HNWI; Foundation

Current Limited Partners: Family Office/HNWI; Foundation

Minimum LP Commitment (Institution): $2,000,000.00

Minimum LP Commitment (Individual): $1,000,000.00

INVESTMENT SIZE

Target Investment Size Minimum: $500,000.00

Avg. Target Investment Size: $1,000,000 - $5,000,000

Target Investment Size Maximum: $7,500,000.00

INVESTMENT STRATEGY

INVESTMENT TARGETS

Primary Investment Region(s): Latin America

Primary Countries of Investment: Brazil

INDUSTRY

Industry Categories: Education; Financial & insurance activities; Human health & social work; Real estate, design & building

Target Industries Description: Real state – focus is in housing (including self construction and financing)

IMPACT

Fund Mission:

Impact Targets: Socially beneficial products; Targeting the underserved; Workforce development; Community development; Socially beneficial supply chains

Impact Targets Description:

Socially Beneficial Products & Services: Access to basic services; Health; Infrastructure/market access; Economic &/or empowerment opportunities; Education; Capital Flow (microfinance, equity, etc); Other

Environmentally Beneficial Products & Services:

Rating Status: Preliminary Rating

Rating Date: 2/8/2012

Fund Name:

Vox Impact Investing Fund I

FUND RATING REPORT

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FUND MANAGEMENT ASSESSMENT DETAILS

	Points Earned (200 Pts Avail.)	% Points Available
OVERALL RATING	**142.5**	**71.25%**
Targeted for Investment	60.1	85.9%
Fund Manager	19.3	91.9%
Current Fund	40.8	83.3%
Investment Criteria	33.8	75.1%
Positive Impact	33.8	75.1%
Portfolio Management	38.0	54.3%
Mission Lock	8.8	50.3%
Mission-Aligned Exit	0.0	0.0%
Capacity Building	16.0	91.4%
Portfolio Reporting	13.2	75.4%

TARGETED FOR INVESTMENT

What % of total assets under management (as a fund manager) are impact investments?	>75%
What % of your total fund targets impact investments?	>75%

INVESTMENT CRITERIA

Does your fund do any of the following to ensure that investees have access to patient and flexible capital?	Delayed principal repayments, Other flexible investment instruments (please describe), Longer than average fund lifetime,
Does your fund's investment agreements with portfolio companies set any of the following expectations for the company's environmental performance, employment/labor practices, and/or	Companies are required to meet all relevant national environmental and labor standards.
Does this process set a minimum bar for investment in terms of social and environmental performance that prospective portfolio companies must exceed in order to receive investment?	Yes - All companies are required to create positive social and environmental value to be considered
Does your fund's Private Placement Memorandum (PPM) include specific language that:	Requires fund managers to consider employment/labor practices when making investments.
Does your fund's agreements with its LPs or comparable agreements include specific language that:	N/A - No LP agreements in place yet.

PORTFOLIO MANAGEMENT

Which of the following types of capacity building assistance do a majority of your portfolio companies receive as a result of investment?	Social and Environmental Performance, Other (Fill in),
Which of the following types of financial capacity building assistance do a majority of your portfolio companies receive as a result of investment?	Other (Fill in), Business Strategy, Financial/Operational Strategy, Capital Raising,
Is the managing partners' compensation and incentive structure at least partially determined by the social and environmental performance of the portfolio?	Yes - Managing partners' carry is at least partially determined by social and environmentally of portfolio
Does your fund have a policy that includes specific screening criteria for potential acquirers or future investors of your portfolio companies that includes the capacity of the acquirer to maintain/expand the company's social or environmental practices?	No

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Rating Status: Preliminary Rating

Rating Date: 2/8/2012

Fund Name:

Vox Impact Investing Fund I

FUND RATING REPORT

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CONTACT DETAILS

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MANAGEMENT

Name	Title	Year Joined Firm	Years of Experience
Daniel Izzo	Co-founder	2009	15
Antonio Marses	Co-founder	2009	10

FROM THE MANAGEMENT

Vox Capital was founded in 2009 with a clear mission: to help improve the lives of millions of low-income people in Brazil. The ultimate goal of everything we do and every company we invest in is to generate the largest positive social impact possible. We believe this will only be possible if we work with entrepreneurs who are building highly scalable companies that deliver a healthy financial return to their shareholders, while being deeply committed to solving an issue that holds back the development of the local BOP population.

In order to fulfill this mission, it is critical to measure our results, both financial and social. The measurement of the financial aspect of the results is already standardized and easy to do. On the social impact side of the story, we are still taking the first steps to create solutions that help us measure and compare our evolution over time. This is a critical matter that asks for a decisive answer if we are to see impact investing take off as a new asset class in the future. For this reason, we at Vox Capital consider the development of GIIRS a key step in the consolidation and maturity of the sector. We can now have a sense of how well we are doing with our impact and also have a clear guide to continuously improve and deepen our positive social impact.

Being a GIIRS pioneer fund is a great source of pride for us. By doing this, we strengthen our leadership as pioneers in the development of the impact investing sector in Brazil and, more importantly, show our commitment towards our mission to investors, entrepreneurs, communities and the impact investing community at large. Our work is just in its infancy and it won't be over while wealth inequality still exists in Brazilian society. For Vox Capital, it is critical to be in the company of partners such as GIIRS, for us to continue working on the creation of the world we all want to live in.

Daniel Izzo
Co-Founder and Executive Director

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10.6. GIIRS – Rating Plano CDE

Rating Status: Preliminary

★★★

Rating Date:

Company Name:
PlanoCDE

COMPANY RATINGS REPORT

GIIRS ratings are third party verified and provide investors with rigorous, transparent, comprehensive, and comparable ratings of company impact. GIIRS helps investors make money while solving the world's most challenging problems. GIIRS Driving Capital to Impact

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COMPANY RATINGS SUMMARY

	Total Pts (200 Pts Avail.)	% Points Available
OVERALL ★★★	91.3	
Governance ★★★★	7.7	51.3%
Related to a company's mission, stakeholder engagement, governance structure, controls, and overall transparency		
Workers ★★★★★	29.600	59.2%
Focuses on how the company treats its workers through compensation, benefits, training, ownership, and work environment		
Community ★★★★	48.9	55.8%
Covers the company's impact on external community stakeholders		
Environment ★★	5.1	25.5%
Focuses on indirect and direct environmental impact of the company and its operations		

COMPANY DESCRIPTION

Sector:
Service

Primary Market of Operations:
Emerging

Industry Category:
Information & communication

Primary Region of Operations:

Industry:
Other info service activities (ISIC 639)

Primary Country of Operations:
Brazil

Products & Services:

Other Countries of Operations:
Brazil

B Corporation?
No

FINANCIAL INFORMATION

Prior Year Revenues:
$2,000,000 - $4,999,999

Current Investors:

Projected Capital Raised in Upcoming FY
$$0.00

Size (# of Employees):
16

Date Founded:

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