Financing civil society

A practitioner's view of the UK social investment market

Venturesome

September 2008

charities aid foundation

CAF

This paper is dedicated to the memory of Sarah Dodds, Director of UnLtd Ventures, and fellow traveller in the social investment market.

Venturesome is a social investment fund, an initiative of the Charities Aid Foundation (CAF). Venturesome provides capital to civil society organisations, operating in the space between providers of charitable grants and providers of bank loans at market rates. Since launch in 2002, over £12.5 million has been offered to some 200 organisations. In addition to accumulating practical deal experience, Venturesome has endeavoured to have a central role in building a robust social investment market, adopting an open-book approach to share knowledge and build experience, but also ready to operate in competition so as to raise standards.

For more information, visit *www.venturesome.org.* If you wish to receive information from Venturesome, please send your contact details to *venturesome@cafonline.org.*

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About the authors

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Contents

Glossary

Capital: in this paper, capital is largely used to refer to financial capital, or money. We recognise that money is just one form of capital – other forms include property, equipment, human resources and so forth. Whatever the form of capital, the term refers to the potential value of assets rather than accumulated assets themselves.

Civil society organisation: the term is used in this paper to apply to the range of organisations that may be eligible for social investment. This includes grant-funded/fundraising charities through to commercial businesses that operate to generate a considerable proportion of profits for charitable spend. More information on the 'spectrum' of organisational models is found in section 2 of this paper.

Development capital: enables organisations to invest in order to build capacity. 'Hard' development capital refers to investment in property or other tangible assets. 'Soft' development capital describes investment in products or services, eg additional staff ahead of related income.

Equity subscriptions: subscribing to shares in a company. Each share represents ownership of a proportion, usually a small one, of the value of the company.

Loan: a sum of money which is borrowed and has to be paid back, usually with interest.

Lock-step model: this refers to an organisational model in which financial return is generated in direct correlation to social impact. Also known as a 'win-win' model.

Patient capital: loans are offered on a long-term basis and on soft terms (eg capital/interest payment holidays and sub-market financial returns).

Quasi-equity: the funder takes a financial stake in an organisation in return for providing the capital for the development of a particular initiative. The return the funder receives is linked to the financial success of the venture.

Social investment: the use of money to achieve both a social and financial return.

Syndication: a lead investor commits to the total funding required, and then sells down the various financial elements eg debt to a bank, quasi-equity to Venturesome.

Trade-off model: this refers to an organisational model in which there is a trade-off between financial return and social impact, ie the more social impact is generated, the less financial return, and vice versa.

Underwriting: an undertaking to provide financing if other sources fail.

Working capital: working capital is the funding required to manage the peaks and troughs of income and expenditure. 'Open' working capital tides an organisation over before it has raised all the money it needs to meet its costs. 'Closed' working capital tides an organisation over before committed funding is paid, by means of a bridging loan or an overdraft.

1 Executive summary

1.1 Context

Over the last five years, the financing of civil society organisations in the United Kingdom has become more sophisticated. In particular, the social investment market which supplies capital to these organisations has developed into a prototype market. However, as with any emerging market, there is a lack of clarity among the participants about the frameworks and parameters, even purpose, of the market place.

In recent months, Venturesome has seen a growing number of additional voices calling for significant steps to be taken to build a strong social investment market. This welcome advocacy appears, however, to be accompanied by confusion regarding the different models of civil society organisations, their social impact and expected financial returns[1]. Clarity is needed. These organisational models have varying financial needs. A supply of capital, comprising a range of financial instruments, is required across this broad spectrum of demand.

Capital is of course no substitute for income, needed to match expenditure on staff and other recurring costs. Capital has a complementary role in building strong and effective civil society organisations.

1.2 Aim of this paper

As a practitioner in the social investment market with six years of deal experience, Venturesome offers this paper as a way of providing clarity in order to drive the development of the social investment market.
It captures our perspective on the organisational models looking for financing solutions from social investors and on the current state of the supply side of the social investment market.

Our vision is of a market, in which access to appropriate capital is no longer a constraint to civil society organisations achieving their social impact. Our emphasis is on the word 'appropriate' in the previous sentence. We do not propose a torrent of money of any sort to flood the market. This paper, our explanations and our proposals are intended to work towards a market, which supplies the most appropriate financial mechanisms, to the organisations able to digest them and use the capital effectively.

1 In this paper, 'social impact' means positive change in society and includes both environmental as well as human considerations. Others may prefer to use 'social outputs', 'social outcomes' or 'social returns'.

1.3 Barriers to the evolution of the social investment market

We believe there are three core barriers blocking further development, barriers which affect both the supply and demand sides of the market:

(i) financial risk aversion;
(ii) lack of understanding of financial needs; and
(iii) the inefficiency of the market place.

Despite the great strides made over the last few years, breaking down these three barriers is a major task.

1.4 Suggested next steps

We suggest three main areas for improvement, largely focused on how current suppliers in the market could collaborate to start to overcome these barriers, so as to encourage a more transparent and efficient market:

(i) increased co-investment, syndications by a lead investor and more pooled funds.
(ii) greater sharing of information and knowledge including, as a first step, collaboration to develop and support research that produces data on the current size of the market, past deals and their performance and transaction costs.
(iii) the development of a common language. This paper is our contribution to clarity regarding terminology.

Venturesome is keen to work with others in all three areas, and together build a robust social investment market so that access to appropriate capital is no longer a constraint on civil society organisations achieving their social impact.

2 Demand-side organisational models

We take the view that social enterprise is an activity (ie trading in a market in order to create social impact), rather than an organisational form, "a verb rather than a noun", and therefore that most civil society organisations have some social entrepreneurs conducting some form of social enterprise.[2] Social enterprise has become a 'catch-all' term, but does not distinguish between organisational models. Those investing in 'social enterprises' are not always asking the appropriate questions to cut through this term and facilitate adequate understanding of the detail of the different organisational structures and how they have an impact on financing needs.

For the purpose of defining the demand side of the social investment market, and disentangling financial risk from expected levels of social impact, we need to specify the different organisational models that exist under the umbrella 'social enterprise' term. We illustrate this in Figure 2.1, which is an adaptation of a diagram we have refined over the years. We have often shown an axis of motivation along the bottom of these rings which shows 'social return' at the far left hand side of the spectrum, 'financial return' at the far right hand side and a 'blended return' in the middle.[3]

Figure 2.1: A spectrum of organisational models[4]

2 Sustainable funding: a basic theoretical introduction, N Wilkie for Civicus, January 2006.
3 For more information on blended value see Jed Emerson's work at www.blendedvalue.org
4 Adapted from *The Venturesome Model. Reflecting on our approach and learning 2001-6*, M Bolton, J Kingston, J Ludlow, 2006.

We have learned that when defining organisational structures in the context of understanding financing needs, it is important not to blur motivation with actual performance; financial return does not necessarily mean a direct trade-off for social return and the balance between the two may shift over time.[5] This is particularly the case in the grey shaded area of the diagram where most of the confusion over definitions exists.

It is important to note that, across the spectrum, Venturesome does not believe that any particular model is inherently more (or less) profitable than any other. Nor is any inherently more (or less) socially impactful than any other. Each model is a means to an end, and not an end in itself. As such, every civil society organisation should ultimately be judged on its actual social impact.

2.1. Charity with fundraised/grant income

Charities operating with income/cash flow funded predominantly by grants and fundraised income.

> eg Street League is a charity that organises sports (particularly football games) for the homeless and disadvantaged, reaching large numbers of young people through sports coaching. Some progress to training and employment, with targeted support, from Street League. Nearly all of Street League's income comes from grant-making trusts, statutory bodies and individual donations.

2.2 Charity with 'on mission' trading/contracting

Charities engaged in on mission trading, ie the trading activity directly furthers its charitable mission, or contracting. The activity may (or may not) generate surplus revenue which is transferred to fund some other part of the charity's work.

5 For example, an individual may establish a charity with the aim of changing society and is therefore focused on its social return, but may discover that their operational model and activities earn them a meaningful financial return, although the financial return was not part of their motivation in establishing the charity. Likewise, an individual wishing to establish a profit-making enterprise and therefore focusing on financial return, may find that their operational model and activities earns them a meaningful social return too.

eg FareShare is a national charity that redistributes quality surplus food to organisations working with disadvantaged people. It has developed a trading activity, FareShare 1st, which collects surplus food from the food and drinks industry. Suppliers pay a management fee to FareShare 1st to distribute it in an environmentally and ethically sensitive way, either through (free) distribution to the organisations described above; commercial sale; or to zoos and city farms.

2.3. Social benefit enterprise

Organisations that operate with a social purpose and where profits are recycled back into the enterprise, with limited distribution to outside (private) investors. They do not, therefore, release financial return or trading surplus to investors in the same way as a commercial business. The enterprise may be managing a trade-off between a financial return and social impact – 'the trade-off model' – or managing a financial return that is generated in direct correlation to social impact – 'the lock-step model'.[6] Either way, the financial return is predominantly recycled back into the business in order to create further social return. This constrained distribution of profits is the common feature. The legal structures for this organisational model vary, but may include Community Interest Companies (CICs) and co-operatives whose entities are either Industrial and Provident Societies (but with regulated distribution of income and assets) or Companies limited by shares. These structures may choose to raise share capital like commercial businesses and unlike charities. Recently, a new hybrid structure, a limited liability company with charitable intent which allows for-profits and non-profits to participate in the same legal structure known as LC3, has been adopted by the US state of Vermont.[7]

eg Women Like Us is a CIC which helps women with children get back to work while helping employers recruit talented staff. Surpluses generated are reinvested in the business.

6 For more detailed explanations of the trade-off model and the lock-step model see *The 3 Models of Social Enterprises: Creating social impact through trading activities, Part1 and Part 2, 2008*, P Cheng, J Ludlow, Venturesome. Available at www.venturesome.org

7 LC3 was pioneered, and lobbied for, by an alliance including Ashoka, the Mannweiler Foundation and the Council on Foundations among others. A bill on the new form is before six other state legislatures in addition to Vermont and a lobbyist has been hired to move it to the Federal agenda in time for the likely revamp of the US tax system in 2009. Those lobbying for the new structure expect it to enable social benefit enterprises to access cheaper capital. For more on this see *A New Template for Philanthropy*, A Wood, Ashoka UK, April 2008. Available at www.ashoka.org/printroom

eg Cafedirect plc is the UK's largest Fairtrade hot drinks company. It executed the UK's biggest ethical public share issue in 2004 to become a publicly listed company, raising £5m from 4,500 investors including its grower partners, consumers and employees. On average, 60 per cent of the profits are invested in the businesses and communities of partner growers. In the event of the sale of Cafedirect, a shareholder would receive equity returns on their investment.

2.5 Socially responsible business

Profit-making commercial businesses which do not operate with a social purpose as their mission, but conduct their operations in a socially responsible manner taking into consideration the social impact of their operations. The traditional view of a socially responsible company, is that the ability to maximise profits may be tempered by the social or environmental return, so they are profit-making but not profit-maximising. However the term socially responsible can mean different things to different people and activities such as 'greenwash' – when a company adopts one environmental policy to cover up for a greater environmental evil – have mired the term in controversy.

eg Patagonia was one of the first socially responsible businesses, founded in 1972 to provide outdoor clothing. Its mission is to 'build the best product and cause no unnecessary harm', and as such produces its clothing using environmentally friendly fibres, including recycled materials. It is a member of several environmental movements and founded the 1% for the Planet alliance, in which businesses pledge 1 per cent of total sales or 10 per cent of profit, whichever is the greater, to environmental causes.

2.6 Business generating profits for charitable spend

Businesses which operate in commercial trading markets but aim to generate profits where all or a significant proportion of profits are given to charity. Profits have to be earned and then spent effectively (on the charity's mission) to achieve any social impact. Businesses that are members of The Per Cent Club (one per cent or more of pre-tax profits are given to charity) would not fall into this category.

eg The common example of off-mission trading activities run by charities is the high street charity shop. Selling second-hand goods tends to be unrelated to the charity's mission (for example, supporting older people, or disadvantaged children), rather, they are designed and run as profit-generating activities, with profits being transferred to the parent charity.

Businesses like The Children's Investment Fund, a successful hedge fund which gives a significant, pre-agreed portion of its management fees and profits to its Foundation to invest in projects supporting children in Sub-Saharan Africa and India, rest in the intersection between this model and that of the 'commercial enterprise'.

2.7 Commercial enterprise

Profit-maximising commercial businesses that do not primarily have a social purpose. These fall outside the organisational models that would receive financial support from a social investment organisation, indicated by the dotted line in Figure 2.1.

eg Legal and General is a financial services company, a publicly listed company in the FTSE 100 Index. It provides life assurance, pensions, investments and general insurance plans, and is responsible for investing over £300 billion worldwide.

3 Capital needs

Just as in the mainstream corporate sector, it would be impossible to quantify what has previously been called 'the near infinite need'[8] for risk capital from the social sector. Experts believe there is significant latent demand, meaning there is more demand than the civil society organisations themselves realise. This point was reinforced by a recent report documenting the impact of the Baring Foundation's ten years of small project grants aimed at strengthening the voluntary sector through capacity building in which one recipient organisation referred to their grant as follows: *"with the glorious benefit of hindsight – a very strategic contribution"*. The charity was not aware of what it could achieve with a small amount of unrestricted funds until it had used them. The report expanded on this point, explaining: *"Often projects had a range of benefits beyond those originally sought. For example, the investigation of a merger leads an organisation to consider the distinctiveness of its mission; the clarity achieved results in a much stronger strategic and business plan and makes it easier to access funding."*[9]

If this can be achieved with a capacity building grant, much more can be achieved with appropriate use of capital investment by organisations with the capability to absorb and use investment effectively. Although 2006 research into charities' reserves by the Charity Commission shows that the proportion of charities with a reserves policy rose from 27 per cent in 2002 to 40 per cent[10], our experience tells us that many small and medium-sized charities' income and expenditure goes on day-to-day activities, leaving little surplus to hold in reserves. This can result in charities being unable to manage cash flow difficulties or invest in development. Whilst revenue generated from grant financing and/or trading activities covers day-to-day activities, regular service provision and ongoing projects, capital investment can help purchase physical equipment, smooth 'lumpy' cash flow, weather difficult periods or invest in future growth. But many civil society organisations struggle to think through these different uses of capital and few generate sufficient surplus to build their own reserves. If accessing outside capital, it is important for demand-side organisations to understand their differing needs:

- in the first instance, an organisation needs day-to-day working capital to exist;
- its second priority is to build up some reserves for financial resilience in the face of unexpected difficulties; and

8 *Sustainable funding: a basic theoretical introduction*, N Wilkie for Civicus, January 2006.
9 *Strengthening the hands of those who do: a review of a decade of project grants awarded under the Baring Foundation's Strengthening the Voluntary Sector Programme*, M Bolton, 2008. Available at www.baringfoundation.org.uk
10 *Tell it like it is: The extent of charity reserves and reserves policies*, Charity Commission, November 2006. Available at www.charity-commission.gov.uk/publications/rs13.asp

- next it will require growth capital – daily operations can tick over successfully without it, but it provides the opportunity for seizing opportunities, an expansion plan or strategic development.

The social investment market enables organisational models 1-6 on our spectrum (Figure 2.1 on page 7) to access capital in the space between grant funding or self-generated revenue and commercial debt. Capital need is a function of many different factors – not just organisational model – including size, maturity and financial structure of the organisation. All of the models described in section 2 may have the same needs at different stages in their development, and all of them would recognise the three areas described above when developing a capital resourcing plan.

3.1 Financial needs

Balancing risk and return requires clear communication about financial and social returns, since it is those returns which have determined the social investor's willingness to invest.[11] Below, case studies of Venturesome clients illustrate how different financial needs are met with different financial instruments. More information on financial instruments is found in section 4, on page 24.

3.1.1 Fixed asset acquisition or 'hard development capital'

Investment in property or other tangible assets which tends to be low risk since property or physical equipment can generally be sold for close to the purchase price less depreciation. It is frequently financed by a secured loan or standby facility. There is increasing evidence of mainstream banks offering mortgages to civil society organisations for building purchase – Venturesome has offered supplementary facilities alongside mortgages in several cases.

11 This is different to the demand side where motivation and performance can differ as explained on page 8.

Sefton Carers Centre

Hard development capital – building purchase with rapid completion

Unsecured loan

This Merseyside organisation is one of the leading suppliers of support services to carers in the UK. Its operations were consolidated into one accessible site which it was renting, when the building was offered for sale for £1.2 million in a competitive situation. It was the only suitable building in the area for the centre's needs and so it was essential that the charity acquired the building. The charity had to move fast to secure the purchase. Whilst the charity already held some reserves in current assets (c10 per cent of turnover), additional finance was required.

Venturesome knew that any loan would be fully drawn down, but judged that the excellent management team would manage the financial position carefully. The attractive location and style of the building meant it was a positive asset which could, if necessary, house additional tenants for surplus income or if all else failed, be sold again.

A commercial bank offered the charity a 15-year mortgage (at 80 per cent of value/cost) at 1 per cent over the base rate which was to be repaid from operating cash flow. A 3-year capital repayment holiday was also made available if required. Venturesome offered a 3-year development capital facility for £150,000, in the form of an unsecured loan to cover the remaining finance required, enabling the charity to proceed. The loan was to be repaid on an agreed schedule through surplus cash flow from continuing activities and extra fundraising. The interest rate was fixed at 6 per cent on funds drawn.

Sefton Carers Centre has performed exceptionally well both operationally and financially, achieving surpluses and repaying its borrowing on a monthly basis.

3.1.2 Bridging finance or 'closed working capital'

Working capital that can underpin a short-term cash flow shortage and tide an organisation over before an already committed grant is paid. This is at the low end of the risk spectrum in investment terms, since the grant money for repayment has already been committed. It is frequently financed by means of a bridging loan.

Questscope

Closed working capital – to cover funding gap for grant paid in arrears

Unsecured loan

This UK-registered charity operates in the Middle East, especially Jordan, helping marginalised young people improve their lives. It had secured a European Union contract for a total of £65,000, but it was to be paid in arrears meaning that Questscope would have to spend the money up front and then claim it back. Although Questscope keeps some reserves, a significant proportion of those reserves were restricted to specific projects and could not be used to cross-fund programmes, even temporarily. This meant that the EU contract presented cash flow problems. The grant was already committed and a track record of previous EU payments on time and in full suggested that this commitment was certain.

Venturesome had a positive track record with the strong Questscope management team, having offered, three years previously, a similar working capital facility that was fully drawn down and used to bridge receipt of funds from the World Bank. It was repaid in full slightly ahead of schedule. This application is not as low risk as an asset purchase since an asset can generally be sold again, but it was considered fairly low risk given that the requirement was to bridge a funding gap.

Venturesome offered a £60,000 unsecured loan facility available for fifteen months, at a fixed interest rate of 6.5 per cent on funds drawn. The loan was drawn and repaid ahead of schedule, upon receipt of the EU grant money which was due in the thirteenth month.

3.1.3 Reserve capital or 'open working capital'

Working capital that can tide an organisation over before it has raised all the money it needs to meet its costs. It may need to act quickly to secure a property or hire (or keep) critical staff. This is higher risk in investment terms since future income is not yet committed, although there is an expectation of the possibility of profits or surplus in the future with which to make repayments. Open working capital is likely to be financed by an equity or quasi-equity investment or with patient capital in the form of an unsecured loan, overdraft or standby facility.

B-Eat

Open working capital – to cover funding gap from lumpy income

Standby facility

B-Eat is the leading UK charity providing information, training and advocacy on preventing and treating eating disorders. It has a range of funding sources, but its income can be 'lumpy' whilst expenditure has a more consistent pattern. In 2007/08 it identified a potential need to bridge this lumpiness.

One option might have been to manage this lumpiness by cutting costs – but this would be detrimental to service levels and damage capacity for future growth, particularly given that over the previous three years it had increased its personal contact with sufferers and carers by 20 per cent per annum demonstrating high social impact. Furthermore, despite lumpy cash flow, the charity's track record showed that average income could be expected to meet average expenditure. The charity was developing its fundraising pipeline and so there was good visibility on expected income for 2007/08, which suggested that the overall trend would be sustained, although there was no certainty of this.

The lack of certain income means that the financing risk is higher than a situation where the income stream is confirmed. However, historical patterns suggested adequate income and Venturesome had a positive track record with B-Eat having offered, two years previously, a small loan that was fully repaid on schedule.

Venturesome offered a £60,000 working capital standby facility in the form of an unsecured loan. The interest rate was fixed at 8 per cent on funds drawn and the facility was available for 6 months, extendable for a further 6 months based on satisfactory performance. If the money had been borrowed, repayment was to be at B-Eat's option but in any event in 36 monthly instalments. In the end, the facility was not drawn as B-Eat's fundraising was successful. The security of the 'safety net' offered by the facility enabled B-Eat to proceed with confidence.

B-Eat is now working with Venturesome to develop other sources of income that will help to tackle the lumpiness of cash flow.

3.1.4 Growth capital or 'soft development capital'

Capital used to support the start-up or significant growth of a charity and the development of its products, services or projects which may generate surplus income. This is the highest risk financing in investment terms and the most difficult for organisations to access, and, not surprisingly, is in high demand. Financial instruments such as equity, quasi-equity and patient capital can support and supplement grant funding for such capacity building.

Charity Technology Trust (CTT)

Soft development capital – to finance growth and strategic development

Quasi-equity investment

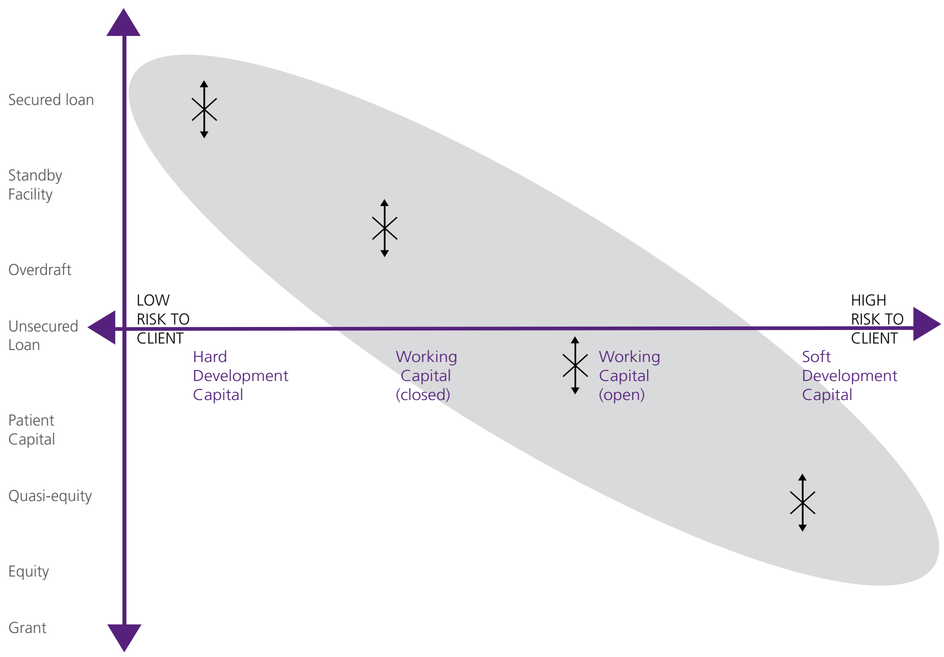
CTT works with charities to help them become more efficient through the use of information technology. In 2006, the charity began developing a technology donation portal, CTX, supplying brand-name software at very low cost to charities. It required up to £100,000 of investment in infrastructure and marketing to enable it to launch and market this portal. Initially, Venturesome provided a bridging loan of £50,000 to provide confidence to the management team as they fundraised for development capital, and a working capital standby facility of £50,000 to underpin cash flow as the charity's core operations grew.

CTT had difficulties in accessing grant funding, however, as it transitioned to a more commercial model. So, in 2007, Venturesome offered the charity a further £50,000 in the form of quasi-equity (a 'revenue participation right'), with repayment to come from a share of future gross revenues (2 per cent). The facility was offered over seven years, with repayment capped at double the initial investment.

This was high risk, since although increased sales were expected to generate a surplus adequate to repay the investment, there was no definite revenue. Furthermore, despite management's strong track record, there was no certainty that the new, scaled-up business model would work, although CTT's forecasts were based on reasonable and well-researched assumptions. Over a year later, sales are going well, and repayment of the quasi-equity facility has already commenced. Repayment of the previous facilities is nearly complete.

Figure 3.1 below illustrates the four main categories of financing needs and the instruments that address them. The financial need should be matched by the appropriate financial instrument. Our experience tells us that the greatest need is for the highest risk development capital that may be funded through quasi-equity, equity and capacity-building grants, as illustrated in the diagram.

Figure 3.1: Matching financial needs to financial instruments



3.1.5 Meeting changing needs over time

Some of the examples above indicate how Venturesome has been able to offer multiple instruments over time to meet changing needs, just as banks and other financial suppliers would to a commercial business. The GAP case study below is a further example of this, and one where Venturesome has been able to co-invest with others in the market.

Global Action Plan (GAP)

1) Open working capital and soft development capital – underpin cash flow and support development

   2005: Unsecured working capital facility and development capital facility as reserves loan

2) Soft development capital – to rebuild balance sheet and support development

   2007: Quasi-equity investment

GAP was established in 1993 to deliver practical activities in the home and the office that protect and improve the environment. In 2005, when GAP had income of around £1 million which was 80 per cent grant funded, it was suddenly hit with a cash flow shortfall due to changes in the landfill tax credits scheme hitting their grant income, together with ongoing losses from a magazine project. GAP closed down its magazine, but it wanted to carry on with its environmental project and it needed to grow its trading income to survive.

GAP approached Venturesome for a £100,000 loan, in order to underpin its cash flow in this sudden difficult period and to build on the start it had made in developing a more diverse and resilient funding base, including increased earned income. It was high risk, since there was no guarantee that GAP could generate enough surplus to restore financial health and to pay back a facility.

However, the projections were evidence-based and the management team competent, so Venturesome offered a £100,000 facility (in two tranches) available for twelve months.

This comprised a £50,000 unsecured standby working capital facility to stand alongside an overdraft from the Co-operative Bank to underpin cash flow over twelve months, structured to encourage early payback with interest at 6 per cent, rising to 8 per cent over the 3-year borrowing; and a £50,000 development capital facility as a reserves loan with interest of 6-7 per cent over the borrowing period, to provide base capital as GAP's new strategies were implemented.

In early 2007, GAP and Venturesome reviewed progress. Income had grown and repayment to Venturesome was on schedule. But there was now not enough money to fund working capital needs. Financial control had been tightly managed, but cash flow pressures were taking up significant management resources and limiting development. Strong trading performance (eg from selling environmental audits to corporate clients) was expected to make the balance sheet positive again in 2008, although there was no certainty of surpluses.

A £50,000 additional loan was advanced in spring 2007 with an agreed objective to raise base capital in 2007/08. In autumn 2008, GAP was invited to apply to a joint Esmée Fairbairn/ Venturesome funding pilot project. GAP was offered a joint £200,000 quasi-equity investment (a revenue participation right at 2 per cent of audited gross revenue for five years). A £50,000 grant from the Esmée Fairbairn Foundation was also offered to strengthen the balance sheet and provide working capital headroom. GAP achieved substantial growth in 2007 and 2008, alongside generating significant surpluses and strengthening its balance sheet.

4 Supply of capital

When Venturesome was founded in 2002 the social investment market was embryonic, with few active players. The Venturesome risk model aimed to support the development of the market by showing that the existing polarised market (offering mainly grants with a small amount of senior debt) could be bridged with a range of non-grant finance to meet the diverse financial needs of civil society organisations as explained above.

Now, in 2008, the supply of capital that meets those needs has grown significantly. Market participants talk about a £1 billion market, but there is no robust data to back up this estimate as the market lacks transparency. This also means that many of the deals in which inappropriate financial instruments have been used to address poorly understood financing needs are 'hidden'.

Figure 4.1: Examples of suppliers, mapped to financing needs

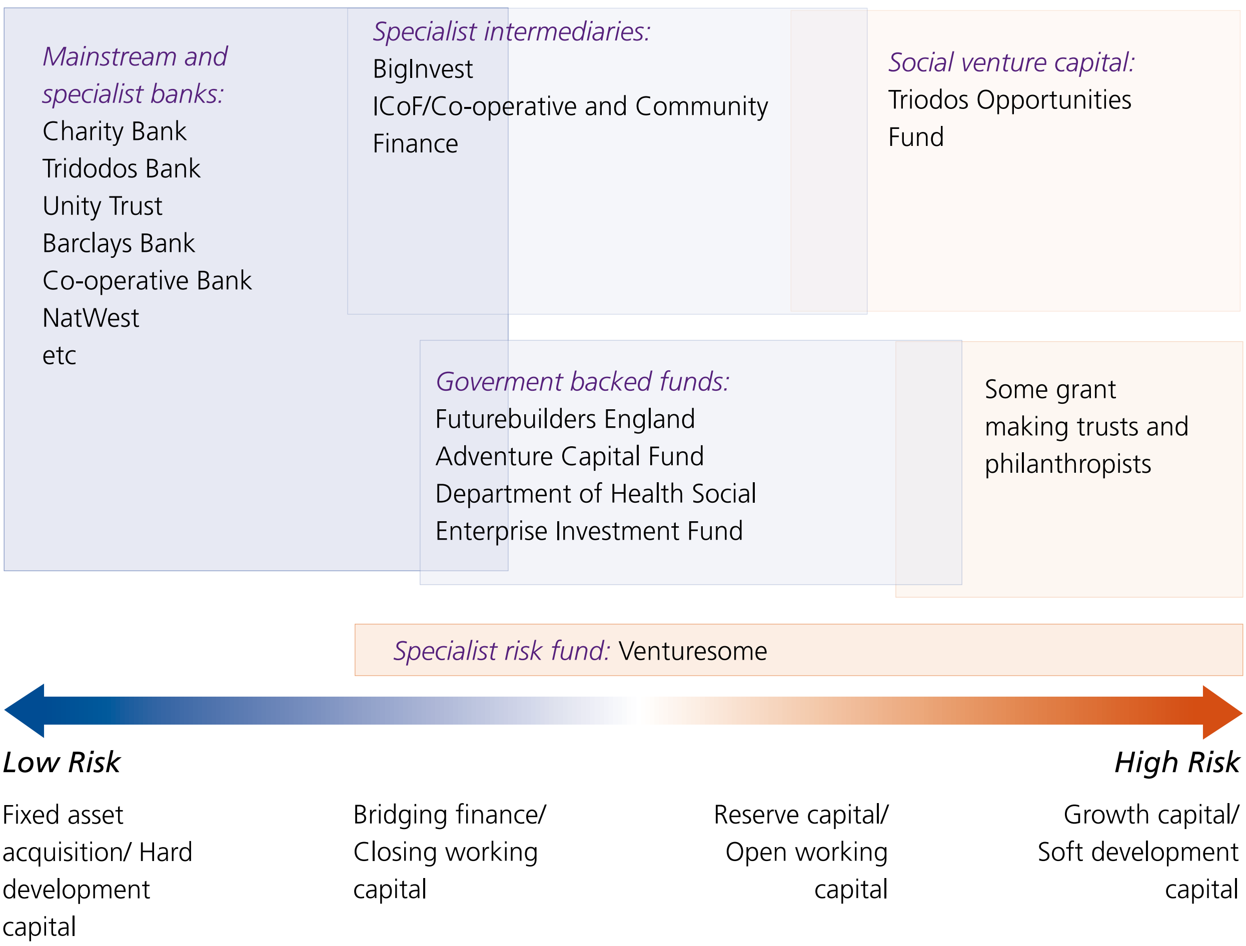


Figure 4.1 above shows some of the suppliers of capital plotted along the horizontal 'needs' axis used in Figure 3.1 of the previous section. Despite the entry of these specialist suppliers into the market and the growing participation of mainstream banks, our experience indicates that the majority of supply is at the low risk end of the spectrum, predominantly secured loans for fixed asset acquisition.

As Figure 3.1 illustrated, the higher risk needs in the start-up phase are best met by capacity building grants, equity or quasi-equity investments, whilst at the other end of the needs and risk spectrum, fixed asset purchases are often financed with secured loans or overdrafts. However, there are many different factors that determine the risk profile and the appropriate financial instrument for each organisational model. The risk profile to the supplier depends on the size of the investment, the use of capital and the stage of the organisation's development. The risk profile to the civil society organisation depends on the terms of the financing offered as well as the structure of the deal. We explain how we understand the supply side in Figure 4.2 overleaf which shows the range of instruments on offer, their basic risk profile and examples of who offers what, with the shaded area highlighting the products Venturesome and other specialist providers currently offer. Below that we provide more detail on the different financial instruments currently being used in the social investment market.

Figure 4.2: Financial instruments and risk to supplier and civil society organisation

Examples of suppliers	Instrument	Financial risk to supplier		Repayment risk to civil society organisation
Baring Foundation, Esmée Fairbairn, CAN Permira Breakthrough	**Grant**	Complete – no repayment		None – no repayment
Triodos Opportunities Fund, Venturesome	**Equity (shares)**	Very high (potential reward also very high)		Low (as linked to success)
Venturesome	**Quasi-equity (royalties)**	Very high (substitute for equity)		Low (as linked to success)
Adventure Capital Fund, Futurebuilders England, BigInvest, Venturesome	**Patient capital (long-term loans)**	High – but repayment expected		Low/medium
	Unsecured loans	Medium		Medium (1-5 year repayment)
Barclays Bank, Charity Bank, Triodos Bank, Unity Trust, NatWest Bank	**Overdraft/ standby facility**	Low – short-term cash flow cover		Medium/high
	Secured loan (mortgage)	Very low – asset backed		High

4.1 Types of investment

4.1.1 Secured loan/mortgage

Secured loans are those that take security on a civil society organisation's assets. There are specialist providers that have been operating for many years, but mainstream banks are also active at this end of the risk spectrum and there is a growing volume of mortgages being made available over long time frames so as to spread the financing impact on civil society organisations. However, the effect of the current credit crunch on mainstream banks in this part of the market is not yet clear. Clara Miller, CEO of the Nonprofit Finance Fund in the US, recently wrote: *"the availability of debt from banks tends to wax and wane…When there is a general tightening of credit during tough times, the non-profit practice is the first to be scaled back because it is not core business for most banks."*[12]

4.1.2 Standby facility and overdraft

Standby facilities are frequently used to allow organisations to commit to projects for which they are fund raising before their fund raising efforts are complete – for example committing to the capital costs of building projects or committing to start a project which is funded by grants paid in arrears. Overdrafts typically underpin cash flow requirements and are available from commercial banks and specialist lenders (often as a standby facility). Venturesome's experience in standby/underwriting provision is that it is frequently used as a safety net, but not drawn down – since launch, approximately nine out of ten underwriting commitments made by Venturesome have not been drawn down.

4.1.3 Unsecured loans/patient capital

Unsecured loans are those that do not take security on a civil society organisation's assets. These tend to be the loan of preference to charity enterprises since few have significant assets to secure against. Additionally, secured loans require more detailed due diligence and documentation which would likely act as a deterrent to trustees already grappling with the new concept of taking on debt. Supplying unsecured loans differentiates social investors from mainstream banks who generally offer secured loans. Patient capital refers to the terms on which loans are made – those which are offered over an extended period and below market rates, for example, perhaps with a ten year capital repayment holiday.

12 See the *Equity Captial Gap*, C Miller, Stanford Innovation Review, Summer 2008.

4.1.4 Quasi-equity [13]

This fills the gap between debt and equity or grants. Sometimes debt financing is inappropriate or too onerous for civil society organisations, especially in the start-up phase, whilst the use of pure equity is not possible if the organisation is structured without share capital to sell. Grants can be difficult to access for civil society organisations with meaningful trading arms. Quasi-equity is a hybrid between the two – an investor can benefit from the future revenues and financial success of an organisation through a royalty payment which is a fixed percentage of income ('revenue participation'), but also stands to gain nothing if the organisation does not achieve expected revenues (due diligence is critical so as to provide adequate confidence for the investor that the investee company does not treat this as a grant but respects the aim of the revenue participation). It reflects some of the characteristics of equity, without actually requiring an investment in share capital. Participation is typically in revenue not profit since many civil society organisations adopt a structure which is not motivated to make profits for distribution.

4.1.5 Equity subscriptions

Social venture capital is a high-risk investment where equity is injected in order to achieve significant growth, eg to transform start-up or small scale organisations. As more social purpose businesses become investment ready with share capital to sell, the public equity market for these organisations will develop which is important for building a long term, resilient capital base for the social investment market. Despite some high profile and successful initial public offerings in recent years such as Cafedirect in 2004 and Ethical Property Company in 2006, the public market remains small and illiquid. Consumer focus on fair trade and ethical shopping suggests that the potential is significant, but experience would suggest that it takes time for interest to convert into investment behaviour.

13 For more on this see *Quasi-equity: A Venturesome case study in using Revenue Participation Agreements*, 2008, P Cheng, Venturesome. Available at www.venturesome.org

5 Challenges

Despite moving from an idea to a prototype market in the last five years or so, major steps are required to move the social investment market into a more robust market, providing appropriate supply for the social sector.

Grant funding will always be needed, for the majority of civil society organisations. However, as indicated so far in this paper, in some instances, other forms of financing can be more appropriate for particular financial needs. Increasing the efficiency of charitable funds should enable the finite pot to go further and achieve greater social impact.

As such, suppliers are emerging in the public, private and charitable sectors which can broadly be categorised as:

- individual philanthropists/social investors
- foundations engaging in social investment
- government-backed initiatives largely addressing specific geographical locations or policy areas[14]
- specialist investors or lenders[15] and intermediaries offering access to providers of capital[16]

We believe that a robust social investment market requires a variety and diversity of suppliers, providing a range of capital products and committed to the market over the longer term. The current reality is that much of the activity is at the lower risk end of the range of needs, such as secured loans for asset purchase. At the higher risk end of the range of needs, our experience tells us that there is much less supply.

A cultural shift is needed to encourage new and existing supply-side organisations to operate like investors who take risks, ask the right questions to get them comfortable with that risk and articulate their expectations on return clearly, just like a private equity company would do to an investee company, rather than donors of specific amounts or lenders on property assets. Once this shift starts to take place, the market will calibrate so that grant-making trusts and mainstream banks operate cohesively with the specialist providers, layering in the different types of finance required.

14 For example, Futurebuilders England which was established as a pilot to address the lack of capital finance enabling civil society organisations to increase their delivery of public services; the Adventure Capital Fund which was established to fill the gap in the provision of loans for community-level organisations operating in marginalised areas.

15 For example, Bridges Community Ventures uses a traditional venture capital approach to invest in companies operating in economically deprived areas; Charity Bank and Triodos which have been taking customer deposits and re-lending them as affordable loans to charities for many years.

16 For example, UnLtd which supports social entrepreneurs through award programmes, research and consulting including access to finance.

Six years and some 200 charities helped since our launch, we view the key barriers blocking the development of the social investment market to be:

- financial risk aversion;
- lack of understanding of financial needs; and
- the inefficiency of the market place.

5.1 Financial risk aversion

Risk aversion exists on both sides of the market place. On the demand side, civil society organisations which have grown up with a project grant funding approach fear the expense and strategy shift needed to make return payments required by debt or quasi-equity financing. Raising grant funding is of course not without risk. Some also believe that such innovative financing will have an impact on governance or cause personal liability.[17]

Although organisations that approach Venturesome for risk capital have already overcome some level of risk aversion in order to make the approach, it is sometimes just one person who then struggles to persuade the rest of the management team or board of the benefits of taking on loan finance or quasi-equity. In order to overcome this barrier should it arise during the due diligence and investment process, Venturesome provides significant advice and product customisation.

On the supply side, financing organisations generally perceive charities to be higher risk investment prospects than they often are. This is in part due to low levels of financial literacy and the related difficulties some civil society organisations have in communicating their financial needs, but in part due to the approach of financing organisations all along the spectrum from grant-making organisations through to mainstream banks. Mainstream banks seem to retain a general nervousness about the financial resilience of civil society organisations. For example, Venturesome is often asked to provide loans to fund contracts paid in arrears because bank lending is not available, yet this is not very high risk financing as funding is committed.

17 For more on this see *The Financing of Social Enterprises: A Special Report by the Bank of England, May 2003 and Approaches to financing charitable work: tracking developments*, M Bolton and J Kingston, January 2006. Available at www.venturesome.org

Venturesome's higher-than-anticipated recycling rates[18] suggest that taking on a standby facility, loan or quasi-equity financing is not as high risk for either party as they might think. The record of repayments is especially strong in the middle of the risk spectrum, supporting working capital and organic growth of charities and not just at the low risk end of the spectrum supporting closed working capital. We recognise that this is in part due to our approach (due diligence, structuring, monitoring and on-going support), but it is also due to the competence of the charities we have supported and how successfully they have used the capital supplied to them. However, the resilience of Venturesome's model and that of other social investors has not been tested in harsher economic conditions such as those we are facing now, and we have yet to see how this may affect both the demand and supply sides of the social investment market.

Nonetheless, the record of repayments reinforces the arguments regarding latent demand of the social sector mentioned in section 3. Some experts have raised concerns about what Alex Nicholls called *"the limits to absorption of the demand side"* in his paper on social investment for the 2008 Skoll World Forum on Social Entrepreneurship[19], but our experience shows that correctly structured and managed, capital can be absorbed and used effectively in many different situations. In terms of social impact, to date, 11 per cent of organisations financed by Venturesome have outperformed the jointly agreed capacity building target, 74 per cent have achieved expectations and only 15 per cent have not met expectations.[20]

Part of the problem is that the decision-making process of social investors does not always balance financial and social returns. Risk capital providers (ie not secured lenders) should be managing a trade-off between these two aims, yet there appears to be a structured bias towards giving more weight to financial factors than the current and potential social impact. There is a risk that social investors focus more on the expectations of financial returns (or the risks of not achieving profit) than on the opportunity of achieving a certain level of social impact (or the probabilities of not achieving those social returns).

18 By recycling we mean money that has been loaned once, repaid and can be used for further loans. We aim to recycle resources four to five times before exhaustion. Venturesome targeted a recycling rate of 75-80 per cent at the fund outset and is currently projecting a weighted average recycling rate of 87 per cent. Bank lenders would normally project recycling rates of around 98 per cent. The Venturesome model is higher risk hence lower projected recycling rates. However, part of the Venturesome investment process ensures that the Venturesome team works with the investee organisations in order to drive down risk and raise likelihood of repayment and recycling. For more on this see *The Venturesome Model: Reflecting on our approach and learning 2001-2006*, M Bolton, J Kingston, J Ludlow, 2006. Available at www.venturesome.org

19 The Landscape of Social Investment: A holistic topology of opportunities and challenges, A Nicholls with C Pharoah, March 2008. Available at www.sbs.ox.ac.uk/skoll/Research

20 For more information see *Venturesome's Approach to Assessing Social Impact*, 2008, Venturesome. Available at www.venturesome.org

Examples of financial risk aversion

- A charity with £2 million turnover and reserves of £1 million of which a significant proportion is in property is expecting a large reduction in statutory grant income. Despite strong reserves, the charity is unwilling to risk any proportion of them for investment in increased fund raising activity even though it already has fund raisers with a good track record in place. Venturesome offered underwriting to bridge this impasse as a tool to give the charity's trustees more confidence to invest in a fundraising campaign.

- A charity with a long, strong track record has a CEO who would like to take on a loan but cannot convince colleagues or trustees that it is a risk worth taking. Venturesome offered a quasi-equity facility to remove concerns about the risk of taking on debt, but risk aversion remained and trustees were still more comfortable with the grant funding model.[21]

- A grant-making trust declined to support a charity on the basis that if their business plan succeeded, they would not need the money. If it failed, they would be associated with a failed enterprise, and were not willing to take the risk. The trust could not envisage that their grant could allow the organisation to build capacity to help increase its chances of success.

5.2 A lack of understanding of financial needs

We observe that both smaller charities and many of their traditional sources of funding are, not unnaturally, rooted in historical approaches to funding, including a reliance on project funding (often restricted), a focus on short-term survival and little scope for, and attention to, building balance sheet reserves to develop financial resilience. A welcome gradual shift, to build capacity, to diversify income sources and to explore new capital mechanisms, is underway.

Yet Venturesome sees frequent examples of trustees, senior management teams and advisers struggling to structure an organisation efficiently so as to build financial resilience. This occurs among big and small charities alike. Through lack of experience and poor advice they can find themselves unable to analyse their financial needs or understand the solutions provided

21 See page 24 for an explanation of quasi-equity and other financing instruments.

by different financial instruments. A lack of understanding can translate to an inability to communicate effectively with advisers and funders. Whilst the language required to discuss grant funding is relatively straightforward and most management teams have grown with the concept of 'cash-in cash-out' and can discuss a cash flow forecast, the language required to discuss working capital and other forms of finance is more complex and communication can easily break down.

The value of Venturesome and other specialist lenders' support is frequently in helping organisations to unpick their financial needs and understand what kind of funding might be most suitable. Typically, civil society organisations are driven by social rather than financial motives, and can be wary of seeking outside finance as well as on occasion being ill-equipped to do so. Given that the market is still in its early stages, those seeking finance can be unaware of the options available and the relative merits of such options. They can focus in their requests on project-related funding rather than development for their business as a whole.

It is unreasonable to expect that those seeking finance come ready prepared with all of the answers. Nonetheless, where clients can clearly express their needs, dialogue is easier. Conversely, a lack of understanding can act as a barrier, particularly with mainstream lenders.

Although most significant on the demand side, a lack of understanding of financial needs can also be a barrier on the supply side. The Venturesome team has witnessed advisers and funders unable to distinguish between capital and revenue, unable to analyse or stress test financial projections and unable to read balance sheets. Reserves pose a particular problem – they may seem large in absolute terms, but are often made up of restricted reserves, unrestricted reserves and represent fixed assets, or working capital needs. Yet funders can fail to recognise their role and also their restrictions, resulting in charities being unwilling to build up reasonable levels of reserves for fear of being penalised.

Of those civil society organisations which can analyse their financial needs and understand how different financial mechanisms can help, it can be a struggle to present financial information in a uniform manner, as the requirements and financial literacy across the spectrum of funders differs. Communication can still be difficult with suppliers. And on the demand side, whilst a loan or interest rate or overdraft facility are universally well understood, terms like quasi-equity can easily invoke fear if not explained properly. We have seen situations where this lack of understanding, on both supply and demand sides, has led to financial instruments being mismatched to wrongly interpreted financial needs.

Examples of a lack of understanding of financial needs

- The management team of a social purpose business is able to explain month-by-month cash flow forecasts and demonstrate how those forecasts show a need for additional finance, but is unable to go to the next level of analysis in order to separate out different uses of funds and to budget for different business lines within the overall projections.

- A charity was enjoying strong turnover, substantial reserves and an aggressive growth plan. However, the charity's management team was unable to communicate a budget that included any uncertain income and did not have the vocabulary to discuss it. Several development capital solutions (but not a grant) were suggested in straightforward terms, but the team appeared unable to engage.

- A grant-making trust had provided a grant to a charity which also needed a loan to proceed with its plans. However, the charity could not afford to service a loan. If the trust had provided a patient capital loan in the first place, larger than the grant but at 0 per cent (which would have cost the trust the same in foregone interest as a grant), the charity would have been able to service the loan's repayment over the medium term.

5.3 Inefficiency of the market place

Demand and supply do not currently meet efficiently in the social investment market place. There are two sides to this argument – some say if appropriate supply exists, the demand will emerge; others say that until the demand is evident, the supply side will not provide. Regardless, the supply side is increasingly noisy but is still not providing appropriate products to civil society organisations in all cases. A basic issue at present is timing. A timely decision from suppliers is as important in many cases as arriving at the 'absolutely correct' decision.

A further inefficiency of the market is that there is little co-ordination between, and co-investment among, suppliers – thereby making deals labour intensive and expensive to complete. There is also little advice and general infrastructure in the form of brokers and advisers developing alongside the emerging suppliers of capital.

The market is not yet calibrating risk and opportunity. Most grant-making trusts are not operating in a way that can leverage in mainstream finance, whilst banks are not operating in a way that can layer in grants.[22] If the market could calibrate more effectively, then it would fill the gaps and address the needs. Furthermore, new entrants would emerge and the different layers of supply would build up. Currently, supply is patchy and the few operators struggle to move in the same direction because of their different objectives.

Examples of the inefficiency of the market place

- Civil society organisations are being funded by several different suppliers (eg specialist lenders and/or grant makers), requiring them going through multiple application processes, costing more and taking longer than if suppliers were equipped to co-ordinate and co-invest.

- Similarly, after investment, extensive reporting in different formats can be required by a variety of suppliers.

22 A rare example of banks and grant-makers leveraging one another is the Deutsche Bank Eye Fund, launched in 2006. The bank announced a $20 million investment fund focused on the expansion of eye care hospitals in developing countries through the provision of loans and guarantees. The fund is accompanied by a grants programme to provide technical assistance, business planning and training.

6 Next steps

Venturesome's vision is for all civil society organisations, from the smallest grass roots charities to larger social purpose businesses with far-reaching remits, to have access to appropriate expertise and capital that enables them to build their financial resilience.

This requires these demand-side organisations to diversify their funding base. It also requires the supply side to offer clarity with regard to products available and to work in a more co-ordinated manner to calibrate the market. Moreover, the supply side must also ask the right questions of its 'clients' so that it supplies the right financial solutions at the right terms to each organisation, or at least signposts to an organisation that can. If risk is balanced with reward in terms of sources of finance provided by the suppliers, a robust market with a range of suppliers across products and services will emerge – share deals, loans, investment banking-type services – and the financial resilience of civil society organisations will strengthen. The social impact of developing a robust market is difficult to quantify; but it is likely that doing so could revolutionise the sector.

Significant steps are required to get to such a position. This paper is Venturesome's contribution to the market as we see it today, our effort at providing some clarity in the areas of most confusion. We conclude by suggesting some next steps for the debate about how to move the social investment market forward:

1 We would encourage suppliers *to increase the number of co-investments and to explore pooled funds and syndications*.[23] Our deal experience tells us that this will help to build a more cohesive market that increases the supply of capital available and is able to meet the demands of the social sector.[24] However, this type of co-ordinated market requires major changes across the market:

(i) supply side organisations to work together rather than the current practice of believing financial needs are solved by one civil society organisation negotiating one by one with a range of suppliers,

(ii) more brokers, advisers and introducers in order to facilitate the effective meeting of demand and supply. A more coherent and

23 See *The Equity Capital Gap*, C Miller, Stanford Innovation Review, Summer 2008

24 For example, Bridges' proposal of a Social Venture Capital Fund that accesses funds from both high net worth individuals and larger organisations such as foundations – see *Equity-like capital for social ventures*, Bridges Community Ventures, September 2004. Available at www.bridgesventures.com/downloads/social_venture_fund.pdf

transparent market will become more competitive which will also drive down transaction fees, currently high because of the individual nature of every deal and the specialist expertise required.

2 More formal channels for *sharing information and knowledge* may help to co-ordinate the market better and improve transparency. Such information would include case study deals, best practice, worst practice never to be repeated, comparable deal and performance data, pipeline of upcoming deals, new entrants to the market place and latest market developments.[25] As a first step, we suggest that key market players collaborate to discuss developing and supporting research that produces data on the current size of the market, past deals and their performance and transaction costs.

3 Increased collaboration on deals and sharing information and knowledge through research would be greatly aided by the development of a *common language*. If the definitions and terms we have proposed in this paper for demand-side organisational models and supply side investment products resonate with readers, we are keen to establish how to work with other social investment market players to develop commonly understood terms and spread clarity across the sector. A common language will help to engender understanding between the supply and demand sides of the market.

25 www.primakers.net is an interesting US-based example of such knowledge sharing, a network of grant-makers and social investors engaged in or interested to learn more about social investment. The network contains details of a number of transactions made by members, with the aim of aiding learning about effective deal-making and encouraging collaboration between investors. In the UK, in early 2008, Catalyst launched a website providing current and prospective investors with information on the fast-growing UK social business sector (www.socialinvestments.com). In September 2008, Social Finance launched an online Social Investment Hub, a searchable database intended to facilitate connections between the demand and supply sides of the social investment market (www.socialfinance.org.uk/sihub).

7 Final word: join the debate

As indicated in the Executive Summary, the social investment market has come a long way since 2000. We should all be encouraged by the huge and positive changes that have taken place. However, we remain in the early stages of a 'robust' market. Ongoing innovation is required. We need to design and develop products and services that enable a diversity of suppliers to appropriately meet the under-served capital requirements of civil society organisations, attracting funds into the market which can then build scale.

Venturesome is encouraged by the co-investments we have made to date, including with fellow suppliers such as the Esmée Fairbairn Foundation, Charity Bank and UnLtd. We are keen to continue to work with others – both demand and supply side – to reassess what can be achieved.

We hope that some of our suggestions may be the practical steps required to trigger increased investment and to incubate that ongoing innovation, and we look forward to discussing our ideas further. We urge you to join the debate.

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