A DEMAND-SIDE VIEW OF SOCIAL INVESTMENT: informing the relaunch of the Third Sector Loan Fund

SASC SOCIAL and SUSTAINABLE CAPITAL

Social Enterprise UK

CONTENTS

This report was written by Nick Temple on behalf of Social Enterprise UK (SEUK) in March 2017.

SEUK is the national membership body for social enterprises in the UK. In terms of social investment, SEUK chairs the Social Investment Forum, conducts research into demand-side finance needs, and represents social enterprise on Big Potential assessment panels, Big Society Trust board, Social Stock Exchange admissions panel and as a founding partner of Good Finance.

Many thanks to all the individuals and organisations who gave up time to participate in workshops or conversations, and share their insight, ideas and experiences – a full list is included at the back of this report.

Thanks also to the three investors (Big Society Capital, Santander, Social Investment Business Foundation) for their support for this work. And to Ben Rick and Natalie Pinon at Social and Sustainable Capital for their openness, support and thinking throughout.

FOREWORD BY BEN RICK (SASC Co-Founder and Managing Director)

We set up Social and Sustainable Capital (SASC) in 2012 in order to use social investment to support third sector organisations in the UK. The idea behind it was simple. We would provide loans and other investments to charities and social enterprises. The funding would help those organisations to grow. That would mean they could achieve greater impact. Since we are a social enterprise ourselves, that would mean we were achieving our objectives, too.

Getting our investors' money back, with some interest, would achieve several more things. Getting the money back would show that the organisations who took on our investment are financially sustainable. The reason that matters is not about the money for its own sake – it means those organisations can go on delivering impact for longer. Getting our investors' money back would also make our funding go further, because it would allow us to recycle the money into investments in more organisations. Last, but not least, it would show that social investment is financially viable. Over the medium term, this will attract new sources of funding for the third sector.

The Third Sector Loan Fund (TSLF) is the second of our two funds. When we launched it in November 2014, it had a pioneering structure. We worked hard to bring together three different kinds of funding: SIB Foundation provided repayable grant, Big Society Capital invested mezzanine capital and Santander extended a senior debt facility. The structure allows each investor's money to go further, and thus support more impact, than it would have done on its own.

We launched TSLF to address what we believe is a serious funding gap. When third sector organisations want to grow or to develop innovative services, or both, this generally creates a need for extra funding. Private sector organisations can pay for growth or innovation by raising cash from their shareholders. But organisations in the third sector generally have little if any access to new equity funding, and limited reserves. Without fixed assets, many are unable to access secured borrowing, either.

We designed TSLF to address this gap. TSLF provides unsecured loans between £150,000 and £3 million to charities and social enterprises which can show how such funding will help them increase their social impact. TSLF focuses on organisations that work with marginalised, excluded or vulnerable individuals and groups in the UK. It covers multiple sectors, including health and social care, housing, employment, education and training.

We've made two innovative investments in charities and social enterprises through TSLF. We provided finance to social care charity Family Action for a payment by results (PBR) contract; and subscribed to the revenue participation notes (RPN) which we used to support the transport social enterprise HCT Group. But we have seen lower demand for TSLF investment than for our first fund, the Community Investment Fund (CIF). CIF focuses on local, community based organisations.

We believe one reason why we have seen weaker demand for TSLF is the continuing decline in public spending. By reducing the incomes of the larger organisations TSLF serves, this decline makes it harder for them to grow and to innovate.

But we were keen to explore how TSLF could be made more flexible and responsive to the needs of charities and social enterprises, while still remaining consistent with our investors' mandate. We are using the results of the work described below to relaunch the fund. We hope the sector as a whole will find this demand-side view of social investment useful.

EXECUTIVE SUMMARY

Social and Sustainable Capital (SASC) is a fund manager and social enterprise. It was set up in 2012 to invest in charities and social enterprises across the UK. Its mission is to help organisations deliver scalable and sustainable solutions to social issues. It does this by providing simple financing that enables organisations to grow and achieve greater impact.

SASC launched two funds in 2014: the £20 million Community Investment Fund to support community organisations across England and the £30 million Third Sector Loan Fund which provides secured and unsecured loans to charities and social enterprises in the UK. Of the twelve investments made to date (totalling just over £8 million), most have come from the Community Investment Fund. SASC and its three investors - Social Investment Business Foundation, Big Society Capital and Santander - were keen to understand how the Third Sector Loan Fund might be made more flexible and fit for purpose. The ultimate aim is both to deploy funds more quickly and to achieve greater social impact.

SASC commissioned Social Enterprise UK to:

1) Get direct views from charities and social enterprises – a real-time picture of the demand to inform SASC's work and, specifically the Third Sector Loan Fund

2) Undertake workshops and phone interviews independently to get full and frank views

3) Provide qualitative information and insights which could be of use to the wider social investment marketplace

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From this work, consensus emerged on three main issues: flexibility, risk and process.

>> Flexibility – where social investment is too rigid, fixed, localised or narrow, it is a struggle for both the investor and the investee; flexibility of product and of role is required

>> Risk – risk needs to be truly shared and reflected in the price and product, as does the relationship to potential return (social and financial); collaboration rather than transaction could help encourage risk-sharing rather than risk-management

>> Process – changes to the investment due diligence process including setting clarity of expectations upfront, streamlining processes and acting proportionately (again to risk and nature of impact, as well as to organisation size) could make the social investment process easier

Five associated <u>recommendations</u> for social investors and social investment intermediaries are:

1) Review existing product offerings for their ability to flex to potential investee needs, and for their factoring in of risk on both sides

2) Give clarity on what is 'social' (and additional) about your social investment – what else do organisations get, and how seriously do you take social impact

3) Consider collaborations with charities and social enterprises that gain you access to knowledge and understanding, and build on a relationship-based approach

4) Give clear expectations of capacity and resource required for the due diligence process in early communications: this will save everyone time and money, and build better relationships

5) Plan for higher levels of due diligence for profit-with-purpose organisations to ensure mission alignment, investor confidence and social impact assurance

A) INTRODUCTION / BACKGROUND

Social and Sustainable Capital (SASC hereafter) is a fund manager and social enterprise set up in 2012 to invest in charities and social enterprises across the UK. Its mission is to help social sector organisations deliver scalable and sustainable solutions to social issues by providing simple financing so that they can continue to grow and achieve greater impact.

SASC launched two funds in 2014: the £20 million Community Investment Fund to support community organisations across England and the £30 million Third Sector Loan Fund which provides secured and unsecured loans to charities and social enterprises in the UK. Of the twelve investments made to date (totalling just over £8 million), the large majority have been from the Community Investment Fund.

The Third Sector Loan Fund was launched in November 2014 to invest in charities and social enterprises with secured and unsecured loans between £150,000 and £3 million. SASC and its investors, Social Investment Business Foundation, Big Society Capital and Santander, were keen to understand how the Third Sector Loan Fund might be made more flexible: to both deploy more of the money successfully and to achieve greater social impact.

To inform this re-design and re-launch, SASC wanted to get direct insights from charities and social enterprises. So they commissioned Social Enterprise UK to:

- Convene and facilitate workshops to discuss what charities and social enterprises want and need
- Follow up with phone calls to current investees, potential investees and those who got investment elsewhere
- Write up the findings into an internal recommendations document for SASC and their investors and this piece of externally-facing research

This approach had three aims:

1) Get direct views from charities and social enterprises – a real-time picture of the demand to inform SASC's work and, specifically the Third Sector Loan Fund
2) Have this done independently to ensure people felt free to say what they felt
3) Provide qualitative information and insights which could be of use to the wider social investment marketplace

B) METHODOLOGY & STRUCTURE OF THIS REPORT

The methodology for this work was simple, with two workshops held in London and then Birmingham, added to by follow-up phone calls to specific individuals and organisations. This was conducted between the start of December 2016 and the end of February 2017.

The majority of attendees for the workshops were charities and social enterprises, but also included some intermediary and support organisations and representation from TSLF's investors. Attendees were drawn from a list provided by SASC, supplemented by Social Enterprise UK's membership and networks.

In total, just under thirty organisations were involved. They represented a good mix of geography, sector, scale, and organisational type. There was also a good range in terms of engagement with social investment to date, from those with a lot of experience in the field right through to those exploring social investment for the first time. Those representing their organisations came from a range of positions: Chief Executive, Finance Director and Trustee.

All quotes and specific details have been anonymised, as the workshops and calls were conducted in confidence and in line with Chatham House rules to ensure openness.

The workshops and calls were structured around four key areas, and the report that follows is structured in the same way:

1) PRODUCT – this covered types of investment, ideal investment size, length of term, flexibility

2) PRICE – this covered the idea of a 'right price', fixed vs flexible, comparison to other investors, and relationship to risk

3) PROCESS – this covered how the social investor operates: their external communications, due diligence process, decision-making, and ongoing relationship

4) PORTFOLIO – this covered who the investees could or should be, sectors of opportunity, scale and size of organisation to focus on, and the idea of a blended portfolio

At times, these conversations were more specific to SASC and the Third Sector Loan Fund, but also ranged more widely about social investment as a whole – and this forms the main body of the report that follows.

C) FINDINGS & LEARNINGS

PRODUCT

The conversations about product reflected the wide range of needs and asks of the social sector: in short, the answer to the question ‘what product do you need?’ is ‘it depends on our type, stage, size, sector and activity’. For some, it was pump-priming investment which is flexible, risky and able to come in at an early stage; for others, it was about flexible working capital that could respond better to the commissioning environment; for others still, it was about patient, long-term loans which can allow a business to mature and achieve its plans. How patient? Well, a 70 year term was mentioned at one of the workshops.

What this variety means for social investors and the social investment intermediaries is three-fold: the first is that flexibility is very important, the second is that there needs to be a belief that the risk is truly being shared, and the third is that there is room for creativity and innovation.

What do we mean by flexibility in this context? Firstly, flexibility of product: with the ability to understand the changing investment needs of a charity or social enterprise as its business grows and matures. That flexibility of product is about not only the rate and the type, but also the stage it is available and the size of the amounts; for example, some wanted smaller amounts of money than SASC could provide, but others wanted *more* than was possible as well.

Associated with this flexibility of product is also a flexibility of role for the social investor. At times, there was a call for SASC or their equivalents to be the risk-taking venture capital type body; at other times, they were being asked to have an ‘underwriting’ role for public service contracts; and others were asking them to be more proactive and involved in *creating* new opportunities and deals. In short, creating product flexibility is one thing. Asking social investors to play multiple roles as well poses a real challenge for investors which are often relatively low in capacity themselves.

The aspect that came through most clearly in the conversations about product was the relationship to risk. We will return to this in the section on PRICE below, but for most round the table, there didn't seem to be a belief that the upside and downside are really being shared by the investor and investee. Do the terms of the loan the needs of the business or the needs of the investment fund? Most were calling for a clearer relationship to risk in the way deals were done and products were formed.

The third element is about creativity and innovation. What this looked like depended on the different types of organisations, but there was a general feeling that social investors were too fixed and too transactional in their approaches, and that this meant that they (and the sector as a whole) were missing opportunities. Some of the ideas included:

- New ways of developing ideas to replace accelerator programmes which are too slow and too bureaucratic, to encourage more proactive, rapid collaboration
- New payment structures, using grants to pay off the return at the end (to make an investment interest-free) or one large payment at the end if the investment has truly been transformative
- New approaches to commissioning, working with charities and social enterprises, to try and crack this challenge locally; as several present said, “commissioning is absolutely the main challenge” for those in public services

- New joint ventures, part ownership structures and idea development between investors and the social sector providers

The connecting thread running through all of these was a feeling that social investors and intermediaries should be working more with charities and social enterprises in developing and partnering on these new developments – not designing a black box product in a darkened room that has no relationship to what the sector (or its customers) need.

Key Points
- flexibility is the most important thing for charities and social enterprises
- flexibility of product demands an equivalent flexibility in role and skillset among social investors
- the key element of flexibility in the product is relationship to risk
- social investors should consider social sector organisations for collaboration, not just transaction

PRICE

The cost of capital is probably the most-discussed topic in social investment. The pervading view is that the cost is too high and compares unfavourably with mainstream investment rates. This partly depends on your view of what is 'social' about social investment. As this project found, charities and social enterprises have a wide range of expectations that include:

- Cheaper money
- Higher risk appetite
- More flexible
- More patient
- Achieving social impact
- Wrap around support
- Better understanding of sector
- Better alignment with charities and social enterprises

So it is not just a conversation about price, but about what you get for it. Certainly there were participants who felt that the rates were simply too high. But most also felt that price was also about risk and the model (in essence, pricing the deal and the risk) and the scale of potential impact.

To take the first of these: <u>what do you get for the price</u>? There was a clear view that charities and social enterprises saw significant value in the relationship with the social investment intermediary (primarily SASC in this instance); and, particularly, that the investment of time in really understanding an organisation's work and business model was hugely appreciated. To quote two investees:

"The relationship and technical skill in structuring the deal were all worth a couple of per cent to me"

"The social side was their investment of time and intellect to really understand the model: only they were prepared to study the business model long enough and hard enough"

As one other participant put it, social investment can't compete with mainstream banking market rates except in unusual areas or when subsidised: so it needs to give something else.

Again, most said that they felt the key issue was the <u>relationship to risk</u>, rather than a headline rate: indeed, if you have the contract or the right length of lead-in, you can be less worried about the rate. As with the product more generally, people felt that things were too fixed (a flat rate) and there was a 'take it or leave it' approach at times, which didn't reflect the variety of models or needs of charities and social enterprises. Similarly, once a model has been proven, the risk and rate should go down, but there was little evidence or few examples of that happening. It was also about risk internally: for charities, overcoming fear and anxiety within trustees was rarely about a price or rate, but about a cultural shift and decision-making.

This can mean that social investors sometimes find themselves with a conundrum based on the scale of organisation and investment. For the lower risk work, generally, the price is considered to be too high – which means there is no incentive for the investee (especially larger charities and social enterprises) to make a deal. For the higher risk work, the price can be considered as too low (not reflecting the risk), which means there is no incentive for the investor (return is not correlated to levels of risk). This is one of the results of inflexible investment products and processes.

Several people mentioned the potential for different uses of grant in different ways to help with this flexibility: something which the various approaches taken in Access' Growth Fund are seeking to understand better, primarily at the higher risk, smaller organisation end of things. The use of 'blended finance' is something SASC is already well familiar with. Through its Community Investment Fund, SASC launched a pilot programme with the Power to Change Trust (a £150 million foundation set up in 2015 to support community businesses across England), offering a blend of grant and loan to impact driven organisations that have a sustainable business model but that are not in a position to take on 100% repayable finance.

It is worth noting that sometimes it wasn't always price or the rate that had been the barrier to a deal being done. For some, it had been the scale of the non-utilisation fee on top of the interest rate that had been the deal-breaker. For others, a lack of understanding that in some areas, they were *deliberately* not running things in as lean a fashion as a commercial business. For others still, the time, resources and capacity needed to engage and complete a deal was the main barrier, not the price.

Finally, everyone said that the investors and intermediaries should be primarily focused on the potential scale of impact, and that price should correspond to this too, as well as to risk. There were varying opinions on how seriously social investors took impact: SASC were generally seen as taking it seriously and tackling it rigorously in their due diligence, but others were felt to have been only interested in the financials. This is an area where social investors should be much stronger than mainstream equivalents, and where they can demonstrate alignment with their investees in terms of their wider mission. Again, in terms of 'what do you get for it', a shared ambition for a strong *social* return was something all the enterprises and charities wanted to see.

Key Points
- the 'social' in social investment means different things to different organisations
- added value from support and relationship can outweigh price or rate
- social investment is often too inflexible currently to price risk appropriately
- social impact (or return) should be given more attention, in relation to risk and price
- blended finance is important, and can be used in different ways to best meet demand

PROCESS

What was interesting about the conversations and workshops was that, despite an assumption that the majority of the conversation would be on the product, price and portfolio, most time was actually spent talking about the process. Some of the key messages from that dialogue are not hugely surprising:

- Two-way dialogue and relationships are as important as price
- A trusted relationship, with the investor putting in the groundwork, is the bedrock of everything else from there on
- Consistency of engagement with the business is important
- The investment up front in the relationship is key

There were some other interesting aspects about the process which emerged though. One was about the capacity of the social enterprises and charities themselves to engage (and cope) with the process. The second was about clear communications about the process, and about expectations. And the third was about the cost and pace of doing the deal.

The capacity of the social enterprises and charities is of significant importance. It is worth noting that this readiness to engage in the process or to work well with a social investor is not always about scale (though often that does bring the resources and infrastructure and information required) but also about skillset and experience. It was noteworthy that several times it was pointed out that sometimes it can be the social sector organisations slowing down the process, rather than the other way round: as they can overestimate their internal capacity and be a bit optimistic with timescales. As one person put it, "*investment-readiness can also be about the capacity to meet social investment reporting requirements".*

Almost all felt that the due diligence was important and rigorous and useful, but for some it had been a 'shock' or a 'step up' which they had had to get used to. For others, the balance was not right and the process had become too onerous and needed to be streamlined based on complexity, risk or size of organisation: there is a fine line between 'being understood and taken care of' and 'this is too much for us' for some, and proportionality is clearly not being achieved in all cases. Those who had been through it did feel it was useful and had improved their organisation:

"Social investment has forced us to grapple with performance: it's been painful but useful"

Some of these challenges come about because of communications and expectations. Participants across the board called for clarity of communications, but this should not be confused with a call for a simpler, fixed product or, even, for major problems in 'navigating' the market. Most had found their way via an initial introduction (often a nearby intermediary) or via support organisations (such as the School for Social Entrepreneurs and UnLtd) although several admitted they still didn't know the full range of what was out there.

With regard to clearer communications, it was clarity about the *process* and about *expectations* which was called for, not a narrower product or better profile. Several talked about how expectations can be raised when 'doing the rounds', and that it was difficult to get an understanding up front of the genuine resource and capacity needed. Greater clarity up front on this in the initial conversations will prevent time wasted down the line: on both sides.

This relates to the third point: about pace and cost, which are linked. For organisations with projects with specific time horizons or with specific contracts in mind, the pace of this relationship building and due diligence can be too slow. Some of the costs come from legal fees and contracting, but also simply the overhead and opportunity cost of so much resource going into the process. This is obviously proportionately more the case for smaller organisations with smaller numbers in the staff team.

None of the charities and social enterprises underestimated the value of the process – to achieve the right fit and deal – but there was a feeling this could be improved. Social investors should look at the clarity of expectations and the pace that things move at – for charities and social enterprises, getting these things wrong can cost them much more than 1% higher on interest rate.

Key Points

- clarity of the process and of expectations is more important than simplicity of product
- rigorous due diligence is a definite step-up for less experienced social sector organisations
- slow pace and process of the deal can cost far more than small changes in the price
- social investors underestimate the importance of process compared to price and product

PORTFOLIO

This section of the work considered potential areas of opportunity for the Third Sector Loan Fund to focus on. It also set out to gauge how charities and social enterprises would feel about the inclusion of ‘profit with purpose’ businesses in the fund’s portfolio. The thinking behind this was that allowing investment into more commercial organisations might have a positive effect on the fund’s economics. That in turn would allow greater flexibility in the rest of the fund.

Almost everyone agreed that the critical point was the focus on social impact. Participants were therefore relaxed about the inclusion of profit-with-purpose organisations – and clear that this was up to SASC and its own investors. In relation to profit-with-purpose organisations, people did make a number of points:

- Be clear about what you mean by the term, as different people use it to mean different things
- Don’t assume that profit-with-purpose investments will automatically bring better returns: that’s a hypothesis that needs testing
- The levels of due diligence will need to be higher (with regard to mission lock and social impact)
- If other things don’t change (with regard to product flexibility, pricing in risk and a clearer process, for example), then changing the nature of the organisations won’t make a difference

There was no clear consensus on a particular sector which provided obvious areas of opportunity for this or other social investment funds to focus on. A theme that did emerge was a sense that opportunities were arising where two sectors meet; for example:

- Where community transport meets health and education
- Where financial inclusion meets employment
- Where worklessness meets housing and parenting
- Where healthcare meets leisure

Others felt that a geographical focus would work better, though this might require a long-term horizon. Focusing on a particular place could allow a social investor to build and then draw on relationships with networks, communities, community anchor organisations, commissioners, and decision-makers.

When discussion turned to the scale or size of potential investee organisations, not surprisingly a wide range of views emerged. Many people felt that an organisation’s attitude, experience and mindset mattered more than its size or scale. Several people challenged the assumption that larger organisations could necessarily deliver greater impact per pound invested. However, everyone recognised that a single fund could not provide investment for organisations of all sizes. This meant that at least some criteria and parameters were necessary.

Key Points
- most would accept profit-with-purpose as part of a portfolio
- profit-with-purpose investment will require greater due diligence and clarity
- opportunities for social investment may arise at the intersection of areas and sectors

D) CONCLUSIONS & RECOMMENDATIONS

It is worth noting that many of the charities and social enterprises commended SASC (and their investors) for undertaking this work: for many, it was the first time they had ever been asked directly by a fund manager how social investment could best work for them or to directly inform what a fund may look like. Many also felt it was an important time to reflect, take stock and look more broadly at how things can change and improve.

Whilst there were different perspectives and approaches to social investment, largely based on the wide diversity within charities and social enterprises themselves, there was consistency on the three main issues: flexibility, risk and process. These were the areas which conversations and discussions came back to over and over.

>> Flexibility – that where social investment is too rigid, fixed, localised or narrow, it will not work for the investor or the investee; flexibility of product and of role is required

>> Risk – risk needs to be truly shared and reflected in the price and product, as does the relationship to potential return (social and financial); collaboration rather than transaction could help encourage risk-sharing rather than risk-management

>> Process – changes to the process could make the most difference of all; clarity of expectations, streamlining processes and acting proportionately (again as to risk and nature of impact, as well as to organisation size) could change the way social investment is working

From these three key areas and the broader learning taken from the workshops and phone interviews, we have drawn out some key recommendations for both social investment intermediaries and the charities and social enterprises themselves.

Recommendations for ***social investors and social investment intermediaries***:

1) Review existing product offerings for their ability to flex to potential investee needs, and for their factoring in of risk on both sides

2) Give clarity on what is 'social' (and additional) about your social investment – what else do organisations get, and how seriously do you take social impact

3) Consider collaborations with charities and social enterprises that gain you access to knowledge and understanding, and build on a relationship-based approach

4) Give clear expectations of capacity and resource requirements in early communications: this will save everyone time and money, and build better relationships

5) Plan for higher levels of due diligence for profit-with-purpose organisations to ensure mission alignment, investor confidence and social impact assurance

Recommendations for potential investees, the ***charities and social enterprises***:

1) Explore the market either via networks, infrastructure and membership bodies or websites like GoodFinance.org.uk to understand the full range of available finance

2) Be honest with yourself about your capacity, knowledge and readiness to engage with different types of social investor and their process

3) Understand your organisation's appetite for risk, particularly amongst the board and leadership team, before embarking on the social investment path