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Social investment

An introduction

On 14 May 2012, NPC and The Clothworkers' Company held a seminar for trustees who wanted to understand more about social investment. The attendees were exploring whether social investment could be a route increased financial resilience for their organisation.

This report highlights the key themes discussed during the seminar, looking at the spectrum of social investment opportunities, understanding how to assess and manage risk, and ensuring a good fit between the type of investment and the purpose of the investment.

The seminar was chaired by **Iona Joy**, Head of Charity Effectiveness at NPC. The panellists were:

- **John Kingston**, Chair of the Association of Charitable Foundations, and Project Director at Social Finance Ltd. Non-executive director of Big Society Capital and EVPA.
- **Edward Siegel**, Director of Investments for Big Issue Invest Ltd.
- **Kevin Williams**, Chief Executive of the disabled children's charity KIDS.

Introduction

April saw the launch of Big Society Capital, the government's new vehicle to make finance available to organisations tackling major social issues. Big Society Capital has £600m to invest in a range of Social Investment Intermediaries, which then on lend to charities and social enterprises.

This means that there will shortly be a lot more money for existing and new intermediaries (such as Big Invest) to invest, and increasing opportunities for charities to access this finance. Charities and their trustees now need to understand whether social investment could be part of their business model.

Understanding social investment

Social investment is the provision of finance to charities and other social organisations to generate both social and financial returns. As John Kingston explained, social investment tends to be for three purposes:

- **asset purchase** (ie, property and plant);
- **working capital** (ie, cashflow); and
- **growth capital**.

Trustees must not see social investment as a source of income; investments always need to be repaid. Terms of repayment may be more flexible than commercial loans, interest rates may be lower and the investor may be willing to take more risk, but ultimately an investor needs to see a convincing business plan for the return of capital.

Social investment cannot replace lost revenue or plug the gap between income and expenditure. If organisations face this situation then trustees would need to seek supplementary income, or cut activities to close the gap.

> ***'A cashflow problem is not the same as systematic operating losses.'***
>
> **John Kingston**

The Clothworkers' Company

The social investment market

Social investment products range from well-known mechanisms, such as overdrafts and mortgages, to more unfamiliar forms such as quasi-equity and patient capital. When talking about social investment, most people think first about social impact bonds, but these make up a relatively small proportion of the social investment market.

Find out more about the different social investment types at http://www.knowhownonprofit.org/funding/social-investment-1/investment-types

Understanding risk

As custodians of an organisation's strategic decisions, trustees need to think about the level of risk associated with their activities. The trustee boards of both investors and investees vary in their appetite for risk. When applying for social investment, trustees must understand the risks associated with their business model and research to find an appropriate investment product and a close match with the interests of an investor.

John Kingston described how social investments vary according to level of risk for the charity and likelihood of repayment. Loans secured against a tangible assets (for example, mortgages) are normally low risk for the charity and carry high demands for repayment. Working capital (such as overdraft or unsecured loan) is medium risk for charity and provider.

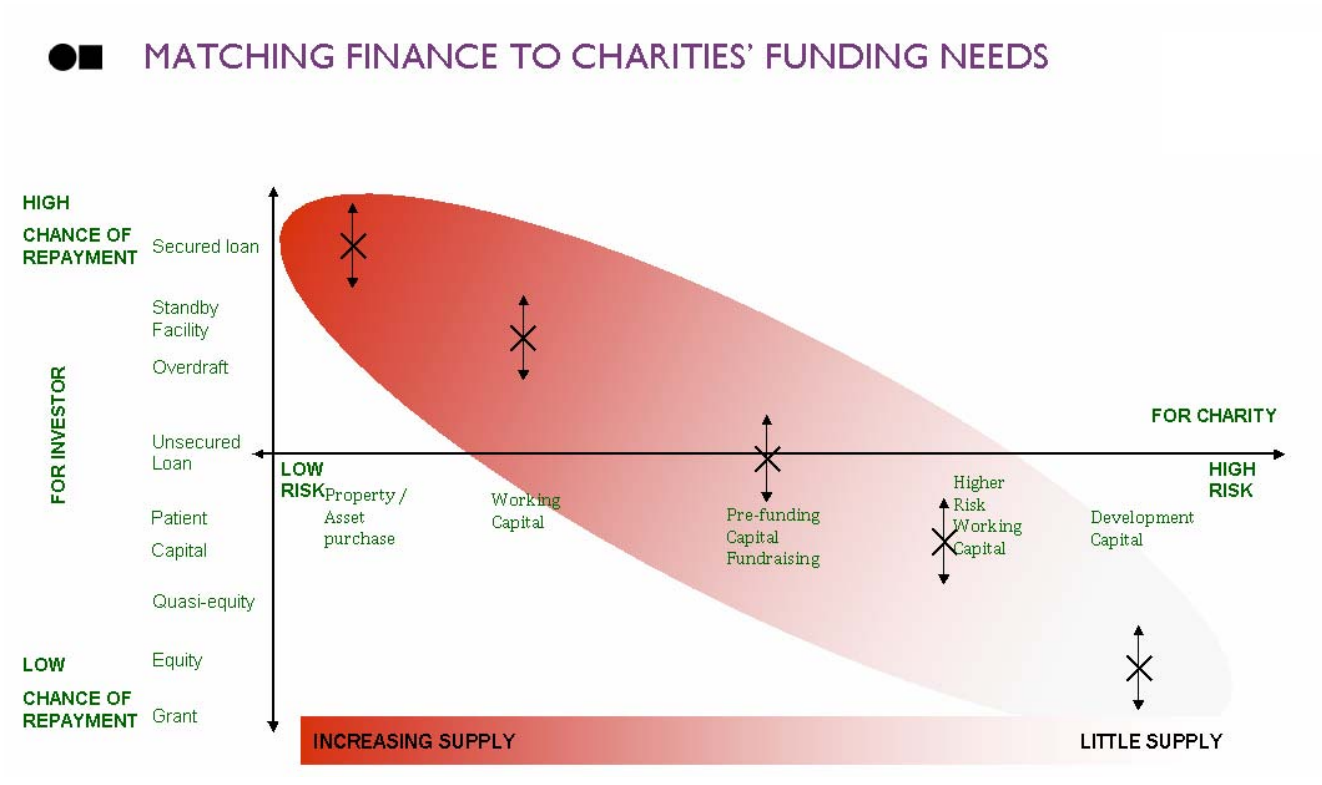
Higher risk investments require a type of investment which recognise the lower likelihood of being paid back, thereby transferring some risk from the charity and its trustees to the investor. These might include quasi-equity which is only paid back if the organisation achieves success in generating financial returns.

At the very end of the scale, grant income has no expectation of repayment, and is therefore suitable for the highest risk activities. The panel recommended that start-up projects focus on grant funding initially, as they are likely to be too high risk for investors expecting a return.

Pricing risk

Some foundations are considering offering social investment as well as providing grants. For trustees of foundations, this decision will mean developing financial models that allow them to price risk—an issue which does not arise when making grants. Social investors generally aim to preserve capital across their portfolio in order to recycle it through different investments. They price investments based on the level of risk adopted, recognising that in some cases the return will be greater than the initial investment, and in other cases they will not recoup their outlay. Riskier investments carry a higher price, in a similar way to commercial investment.

Most social investors are driven by the social impact of the charities or social enterprises supported and not by financial returns. Therefore social investors may tolerate a rate of return below the actual price of the risk adopted and be cheaper than commercial equivalents.



Source: CAF Venturesome

Innovative solutions

Social investors provide innovative investment structures which do not rely on purchase of equity (shares) and therefore suit the charitable legal structure. As Edward Siegel explained, Big Issue Invest attempts to mimic the commercial investment model achieving a higher rate of return when the organisation succeeds, for example by:

- linking the interest rate for a loan to performance, so if the organisation struggles it repays lower interest, but if it thrives it pays a higher rate, or
- purchasing a Revenue Participation Right which entitles the investor to a percentage of turnover for a specified period of time.

Crucially (and in contrast to venture capitalists), many social investors will agree to cap their return, so that even the most successful investments do not provide a perpetual income stream.

Making the decision

Social investment is not suitable for all organisations. Trustees should think about their finance needs in the context of the organisation's wider strategy, and the risk profile of their activities:

- For high risk activities, a traditional fundraising approach may be more appropriate as it will leave the organisation free from financial commitments if the activity does not generate revenue.
- For low risk investments—such as mortgages and overdrafts—a commercial bank, as well as social investors, could be approached.

The purpose of investment

Yet changes in the policy environment and the way that charities are funded means that even when an organisation has historically relied on voluntary income, trustees may now need to explore new financing models, for example:

- An organisation needing to purchase a building to deliver revenue generating services may do so earlier through investment than by raising the full amount through fundraising (**asset purchase**).
- Where contracts offer payment in arrears, organisations will need to cover operating costs while waiting for payment (**working capital**).
- Organisations making a transition from block contracts to payment by individuals for personalised service may need to reform their delivery model to best meet the needs of clients in a competitive market (**growth capital**).

Across all examples, trustees will need to have a clear plan for generating income and repaying the investment made, recognising the level of associated risk.

Understanding your business plan

Before taking your business plans to a potential investor, trustees should go through the figures in detail to ensure that the financial model is robust. An investor will expect to understand the figures inside out, and the onus is on the investee to demonstrate that financial assumptions are sound.

As Kevin Williams explained, KIDS was able to secure social investment despite operating losses, because Venturesome was convinced that the investment would enable the charity to restructure operations, close services which were being subsidised by the charity, and return to generating surplus.

> ***'Ask your chief executive if he or she would invest their own money in the business plan. The answer doesn't have to be yes—individuals may have a lower appetite for risk than investors!—but it will help you assess how convincing your projections are.'***
>
> **Kevin Williams**

There is no standard ratio between the level of debt an organisation can sustain and the level of turnover. Trustees should seek only the amount of investment needed to achieve their aim, and only undertake investments where the interest and repayment commitments are realistic in relation to the organisation's monthly available cash.

Board

Trustees are crucial in making social investment a success. As trustees are ultimately responsible for the strategy of the organisation, their attitudes and attributes have a huge bearing on the credibility of an organisation choosing to take on investment. Edward Siegel explained that Big Issue Invest looked for dynamic boards which focused on making the business model work, rather than being excessively focussed on risks and barriers.

Kevin Williams explained that the trustees of KIDS felt freer to take on the risks of social investment because the organisation did not have historic assets they felt a responsibility to preserve. He insisted that trustees must be willing to apply their professional commercial skills when it came to scrutinising business plans and understanding how investment would affect the charity.

Dos and don’ts for trustees

John Kingston provided some tips for trustees considering social investment:

- Don’t use debt to fund losses.
- Don’t mismatch funding—find an investor who understands your risk and wants to take part in it.
- Don’t believe social investment is a silver bullet; it is just one part of a diverse funding portfolio.
- Do understand your business model and how the investment will be repaid.
- Do watch your cashflow and understand the flow of money into and out of the organisation.
- Do build resilience (ie, reserves)—investors care about the capacity of the whole organisation.

Experience of social investment

Different types of investment will affect organisations in different ways. Investment for asset purchases and working capital can be quite straightforward, but applicants for riskier growth capital should expect considerable scrutiny and trustees must be comfortable with detailed investigation into their operations. While some organisations could find this scrutiny intrusive, Kevin Williams equated the process to free consultancy!

Relationships with investors

Panellists emphasised the need to be honest and open with investors in order to get the most out of the relationship. Once investors have decided to support a project they are interested not only in its financial success, but also the achievement of its social aims; congruent with the investee. Ideally this will generate a relationship of trust where trustees can share problems with their investor and benefit from their expertise.

Social impact

Most social investors will be interested in existing measures of social impact, and trustees should be prepared to demonstrate the difference the organisation makes. Most investors would not insist on a costly framework such as SROI. As Edward Siegel explained, Big Issue Invest has established a Performance Assessment Framework which allows them to compare and aggregate impact indicators across all investees. Big Issue Invest’s investees agree both social and financial Key Performance Indicators at the outset of an investment. Although investees need to perform well financially in order to sustain the fund, Big Issue Invest’s own investors are ultimately most interested in the social outcomes that the businesses are generating.

The future of social investment

The panellists hoped that with the advent of Big Society Capital, new products would develop to fill current gaps in the market. Theoretically competition between investment providers may drive down the price of investment. However most investors price to achieve preservation of capital, and not to make profit, so there is limited capacity to reduce costs. Big Society Capital will expect all intermediaries to achieve a 4% rate of return, so intermediaries will have to price their risk accordingly.

Foundations providing social investment will not be subject to the same requirements when it comes to rate of return and trustees of foundations have more freedom to require a lower rate of return. Some foundations are currently considering diverting a portion of their capital to social investment, rather than investing for profit and dedicating that income to the mission.

Final thoughts

At present the market for social investment is relatively small, but with the launch of Big Society Capital there will be more opportunities for charities with credible revenue streams to access this type of finance.

Social investment requires a robust business plan which stands up to scrutiny. Charities must know their figures inside out and be ready for challenging questions. Trustees need to understand the risk attached to their business plan, identify a suitable type of investment, and match their situation an investor’s interests.

However, unlike commercial investment, the objectives of social investors are closely aligned with those of the investee. They are concerned with the achievement of both social and financial aims, and particularly focused on building the capacity of the organisation.

Further reading

To find out more about the issues raised in this briefing read NPC’s report, *Best to Borrow*, published in Novem 2011.