MAKING GOOD IN SOCIAL IMPACT INVESTMENT

Opportunities in an Emerging Asset Class

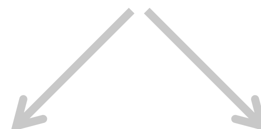
October 2011 | by Dr Rupert Evenett and Karl H Richter

Sponsored by:

The Social Investment Business

TheCityUK

This Review is written from two perspectives



From the bottom-up perspective of social purpose organisations and entrepreneurs, grounded in their needs and comments.

From a financial perspective, beginning to shape what a viable financial prospectus for social impact investment products would look like.

In the social investment arena, building relationships between funders, private and public, will be crucial in attracting new finance to develop the capacity of organisations working to change the world around them.

Jonathan Jenkins -CEO, The Social Investment Business

While measurement of the social impact of those who receive funding will be key to the debate on the role of the social sector, it cannot be at the fore of funding decisions.

Chris Cummings - CEO, TheCityUK

sector3 CONSULTORIA DE GESTÃO

EXECUTIVE SUMMARY

Today's social impact investment market is sufficiently evolved to see the interface between commercial institutions and the social sector become better informed and better understood:

This is an emerging market that has passed a watershed with sufficient investment track record building to start attracting mainstream investment.

It is a growth market. The social sector that produces so much public good, and which could produce more, is undercapitalised. An expanding new generation of social entrepreneurs is combining the values and motivations of the social sector with business acumen and they are proving their ability to use investment capital to increase their social impact and make their organisations more robust and sustainable at the same time.

The social sector, to maximise its potential for creating social benefit, needs a greater choice of capital suppliers and a broader range of funding products of different types and maturities.

The social impact investment market is primarily an intermediate capital market, where investment capital has overlapping characteristics of equity and debt.

Social impact investment can offer investors sustainable financial return, assessable risk and the potential for diversification.

OPPORTUNITY

This is an opportunity for social purpose organisations to secure sustainable, predictable and appropriate sources of funding as they increase their commercial discipline.

Equally, for the financial services sector the opportunity is to mature a new alternative investment class with a large potential for growth and investment in new early-stage growth industries such as long-term care, preventative health and rehabilitative skills and training.

sector3 CONSULTORIA DE GESTÃO

INTRODUCTION

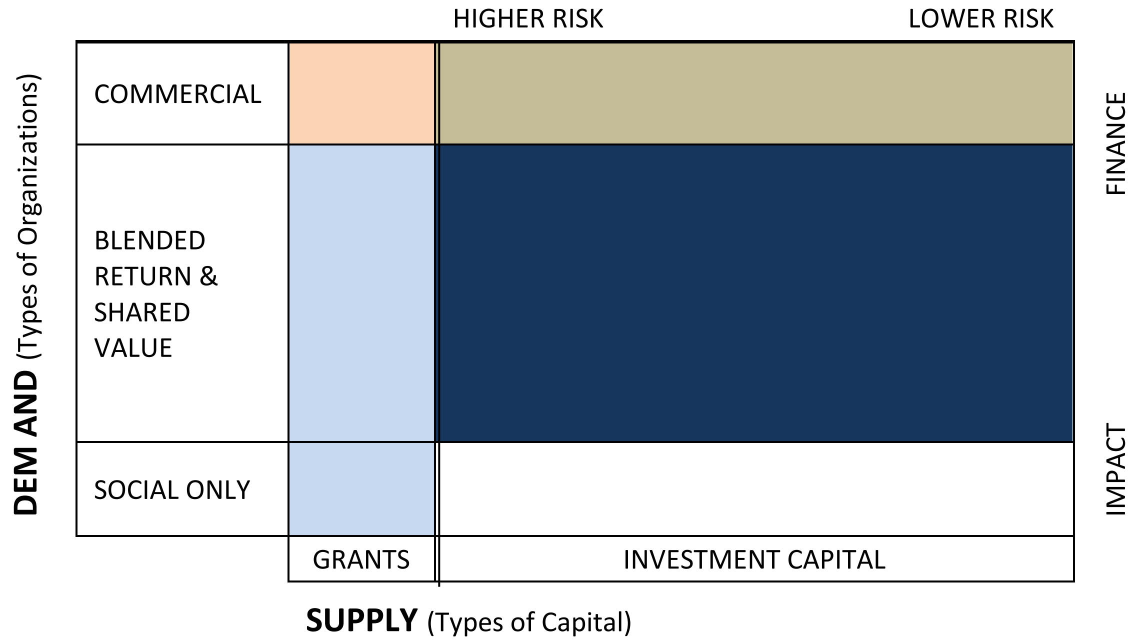
The social impact investment market has passed a watershed. A generation of social entrepreneurs is becoming more sophisticated and experienced, combining the values and skills of running successful social purpose organisations with business and financial acumen.

The challenges are to social sector leaders to provide those successes and to the financial sector to provide the capital the social sector needs.

Our vision for a thriving social impact investment market is one in which social purpose organisations at different stages of development and size can access a wide range of financing products of varying types and maturities.

Social purpose organisations need to free themselves from dependency on a “hamster wheel” of successive one-off funding, the ability to be more strategic in their social missions requires them to be more strategic financially through having access to more diversified and longer-term sources of funding. We argue that it should be identified as an intermediate capital market, recognizing that many of the most interesting financing structures appropriate to this sector occur where debt and equity characteristics overlap.

SOCIAL IMPACT INVESTMENT MARKET



Social Impact Investment Market

Subsidies

Socially Responsible Investment

Charity & Corporate Social Responsibility

WHAT
SOCIAL PURPOSE ORGANISATIONS
NEED
MORE CAPITAL
MORE PLURALITY OF PROVIDERS AND TYPES OF CAPITAL
BETTER GOVERNANCE AND FINANCIAL LITERACY
UNDERSTANDING THAT GRANT FUNDING AND INVESTMENT ARE MUTUALLY REINFORCING
DEVELOPING INVESTMENT READINESS
INVESTMENT TO STRENGTHEN ORGANISATIONS
MEASURING SOCIAL IMPACT
ALERT

THE EMERGENCE OF A NEW ALTERNATIVE INVESTMENT MARKET AND ASSET CLASS

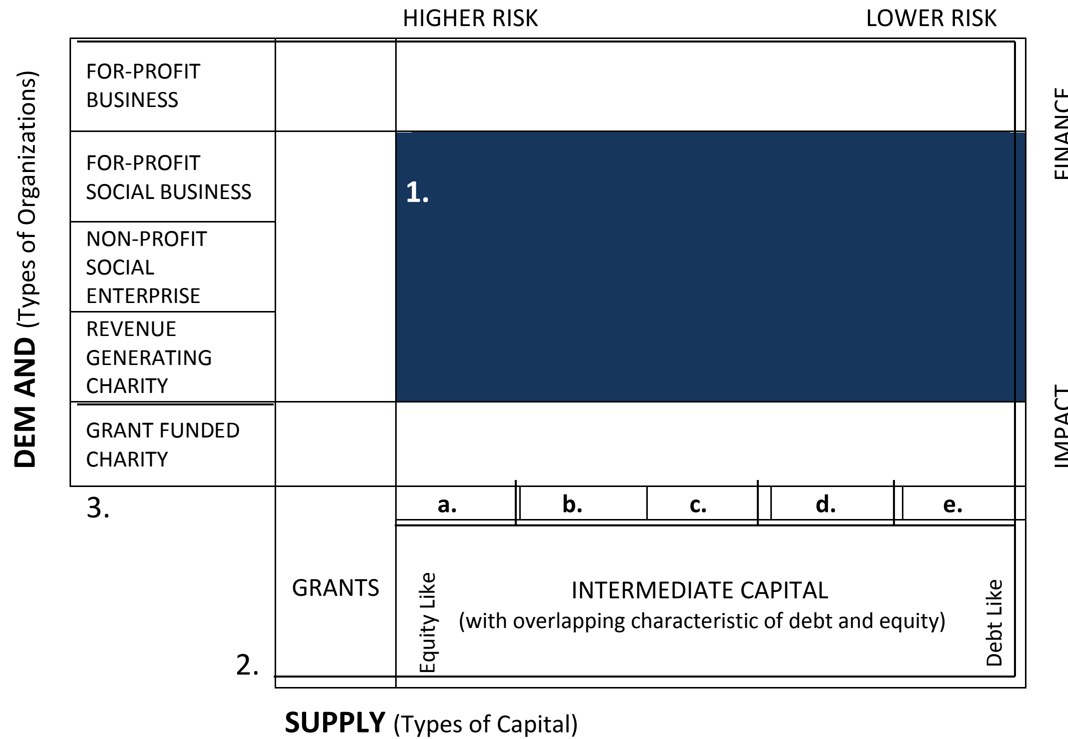
Social impact investment, as an alternative investment asset class with assessable risk, is sufficiently mature to begin attracting financial investors who have an appetite for yield over capital appreciation and diversification within investment portfolios.

It is our view that 2011 will be a turning point in social impact investment as it goes from niche to mainstream.

Entrepreneurs are becoming more expert in finding ways to make their organisations financeable by creating sustainable models for shaping cash flows and generating surpluses.

We felt it was important to find a simple way of representing the market as an integrated whole rather than an array of discrete funding products or organisations, and for it to represent the function of the market as a funding escalator for social purpose organisations (see analytical frameworck on the next page).

ANALYTICAL FRAMEWORK FOR THE SOCIAL IMPACT INVESTMENT MARKET



a. First Loss Angel Funding **b. Preference Share** **c. Subordinated Loans** **d. Unsecured** **e. Secured Loans**

1. The supply of capital to the social impact investment market comprises primarily intermediate capital that has overlapping characteristics of debt and equity.
2. The capital types on the supply axis are arranged broadly according to risk appetite and participation in the performance of the organisation, decreasing from left to right.
3. The organisation types on the demand axis are arranged according to how they prioritise social outcomes; those with greater emphasis on social outcomes at the bottom, those with greater emphasis on financial returns at the top, and those that focus on blended value in between

sector3 CONSULTORIA DE GESTÃO

THE DIFFERENCES BETWEEN THE SECTOR, THE MARKET AND THE ASSET CLASS

We use the term “social sector” to refer to the grouping of all social purpose organisations ranging from grant-funded charities to for-profit businesses, the “social impact investment market” to refer to the realm where providers of investment capital and recipients interact to do deals (it excludes grant funding) and the “asset class” to refer to that portion of the market that comprises capital from investors who seek a financial return on their capital.

PURE EQUITY CAPITAL HAS A LIMITED ROLE TO PLAY

Equity generally seeks to maximise financial value and often prompts behaviours that can be at odds with the objectives of social purpose organisations, whereas philanthropic capital has been seen by the sector as an obvious source of funding for these organisations because it aims to maximise social impact without requiring any financial return. Debt, on the other hand, is a financial instrument that satisfies the minimum requirements of investors because they will accept capped financial returns and it is consequently able to balance social outcomes and financial returns. It is therefore in principle very well suited to financing the social sector alongside philanthropic grant funding. Social purpose organisations, like all organisations, require risk capital but equity investment is often not always the most suitable form of investment capital, for the restrictions imposed by their legal forms, which mostly prohibit private ownership and the issuing of shares.

INTERMEDIATE CAPITAL IS CENTRAL TO THE MARKET

A striking aspect of the social impact investment market is how it has already proven itself to be alive with intermediate capital instruments, even if the terminology is not yet commonplace, whether it is philanthropic capital invested as first-loss equity-like capital or the spectrum of debt capital structured with performance-related aspects, or patient capital debt with tailored repayment and interest schedules, as well as unsecured medium and longer-term debt for working capital and development capital, among others.

Even secured loans can be classified as intermediate capital if providers are prepared to structure the term sheets accordingly. We assert therefore that there is great scope in approaching product development in social impact investment as variations on the theme of intermediate capital and quasi-equity, and equally a great opportunity to expand the existing array of intermediate products as part of a diverse and pluralistic market.

sector3 CONSULTORIA DE GESTÃO

INVESTMENT AND PHILANTHROPIC CAPITAL ARE MUTUALLY REINFORCING

Both investment capital and philanthropic capital are complementary and necessary components in the social impact investment market. Some pundits say that to function effectively, the market requires 10% to 20% philanthropic capital and the rest can be investment capital. This ratio will need to be refined over time by independent data.

The advantages of debt capital

The legal forms of many social purpose organisations prohibit them from issuing equity, but they are allowed to take on debt. The very flexible nature of debt instruments allows the sector to evolve a broad range of financing products that fit the needs and risk profile of social purpose organisations with appropriate terms, maturities and interest and repayment obligations. Debt instruments are simple to understand, can be refinanced to promote liquidity and offer investors speed to market for volume products.

The advantages of philanthropic capital

The presence of philanthropic capital in the market provides a major positive benefit to investors in reducing the risk of social impact investment as an asset class. Philanthropically sourced capital, through its ability to absorb financial risk by taking a first-loss position, can open the door to other investment capital with a more conventional risk appetite. Again, this mostly takes the form of a flexible debt instrument for legal reasons, sometimes as loans but often as extremely patient capital fulfilling the role of high-risk equity-like capital, angel funding or other subordinated capital tranche.

Grant funding is complementary

Some grant funding is both a necessary requirement in strengthening the social impact investment market and can help some social purpose organisations gain a foothold in the market by securing social impact investment.

sector3 CONSULTORIA DE GESTÃO

BALANCING SUPPLY AND DEMAND

SUPPLY SIDE

Capital does flow into the market but not at the levels that social purpose organisations require. The feedback from recipients of funding reveals that finance is not available in sufficiently diverse forms and is also often lacking in capacity-building support. The distribution of capital is fragmented and the range of products could be expanded with more longer-term and flexible capital to support the strategic business planning of organisations. As a general observation, more commercially minded investors are likely to be more comfortable on the right-hand side of the supply spectrum, which resembles more plain vanilla debt and loan products, and probably also more likely to provide capital to for-profit social purpose organisations than non-profits, while more socially minded investors will be likely to accept higher risk exposure as well as engage nonprofit and charitable organisations.

DEMAND SIDE

Most social purpose organisations are geared up to receive grants instead of investment capital, whether for start-up capital, strategic growth capital or working capital. For some this is and will remain the most suitable form of funding. Many others, including the most enterprising, are often caught in the “hamster wheel” of continual one-off grant funding cycles. And many social purpose organisations report a growing appetite and need for capital. The result is a radical mismatch of supply, particularly across the intermediate capital area. There is an opportunity to proactively combine packages of finance with upfront funding designed to help organisations improve their investment readiness and follow-on funding to support their primary activities.

sector3 CONSULTORIA DE GESTÃO

CHALLENGES OF CREATING AN INTEGRATED MARKET (I)

Fragmentation of capital supply

The absence of a joinedup and plural range of capital is limiting the social sector in developing more strategic social purpose organisations with more sophisticated, innovative and sustainable business models. This is a challenge to existing and new providers of social impact investment capital to introduce a greater range of funds and intermediaries, with more choice and competition for social sector organisations, and to develop a greater range of products that include follow-on as well as initial funding.

Business support for social purpose organisations

Applying for grant funding requires different skill sets to writing an appropriately robust business plan or an investment prospectus. Marketing skills are often lacking and there is a real need for technical assistance to improve financial skills, from cash forecasting to understanding basic investor requirements such as for-information reporting.

CHALLENGES OF CREATING AN INTEGRATED MARKET (II)

No universally agreed metrics for social outcomes

Measurement of social outcomes is agreed by many (including us) to be a vital component for this sector, yet there is no common unit of measurement or system to compare the social benefit of different investments. Many “finance first” investors are concerned with social outcomes, at the very least to provide assurance that they invest in something that delivers social benefit, but from a pragmatic perspective they will typically be more focused on usual issues such as investment risk, financial return and robustness of trading data. Some metrics for social outcomes are gaining global support, such as SROI (social return on investment) and GIIRS (global impact investment rating system), although they can be bureaucratic, labour-intensive and costly to implement. Feedback from social purpose organisations says that no one template for measuring social impact will fit all organisations, thus causing difficulty in comparing like with like. Good proxies or leading indicators for impact can be developed but an overemphasis on “precise” measurement of social impact can quickly become burdensome and just another cost. It is practicable to undertake broad-brush tiering of social purpose organisations by impact, in terms of those organisations that indisputably demonstrate “high impact”, can only demonstrate “good impact”, have “unproven impact” or “no quantifiable impact”. In the absence of standard metrics, whichever methodology an organisation chooses to use should be applied consistently across projects to assist with comparability.

sector3 CONSULTORIA DE GESTÃO

CHALLENGES OF CREATING AN INTEGRATED MARKET (III)

Absence of clear market signals

The social impact investment market is complex and sometimes contradictory without universal market norms of how philanthropically sourced capital and commercial capital can be conflated into social impact investments. There is an energetic debate about whether social impact investments should be expected to deliver market-rate returns or whether below-market returns must be accepted to counterbalance social outcomes. Both arguments should be accepted as valid descriptions of the two ends of a spectrum.

Restrictive regulatory and legislative environment

We have argued why a range of capital sources can serve the needs of the social sector, yet when it comes to taking on debt, the social sector has traditionally been risk-averse and regulators have in the past been sceptical of blending commercial and philanthropic capital, in other words capital that seeks both financial returns and social outcomes. New legal forms are being advocated such as the social enterprise limited liability partnership (SELLP), which would allow charitable and commercial interests to be combined within a single and transparent legal vehicle.

CHALLENGES OF CREATING AN INTEGRATED MARKET (IV)

Insufficient incentives

A new market needs to be catalysed, requiring incentives to accelerate its development, attract new market participants and increase the enthusiasm of existing participation until the market is established. The government has recently announced plans to increase the ISA limit by £200 for social projects to encourage investment in social purpose initiatives. Ideally, a package of tax incentives and guarantees will be available to encourage institutional and private investors, particularly because investors are often driven to look to tax advantages as a primary criterion for investment decisions, making performance secondary.

Need for deal-broking

Broking as a necessary part of the overall social impact investment model should be a central feature of how this market emerges. This is because there is misalignment between the sort of opportunities investors are typically seeking and the range of opportunities on offer. It is often difficult to bring together suitable capital and capable social purpose organisations because there is poor signposting, application procedures vary and the requirements of investors are so specific that applicants often cannot satisfy all the criteria. Capital often does not know where the best opportunities in the social sector are or how to identify them. Social purpose organisations do not know where the most appropriate sources of capital are or how to access them most appropriately. A good broker is an essential intermediary in bringing them together and can also help with other issues such as the procurement of business support. The problem is that broking is labour-intensive, though highly value-adding, and its costs needs to be factored into the equation. Social investors should give consideration to where their own core competences lie, how much business support they provide themselves and how much is best done (for both economic and competency reasons) by specialist third-party suppliers.

THE GLOBAL CONTEXT

sector3 CONSULTORIA DE GESTÃO

THE ANGLOPHONE DEVELOPED WORLD

The principle of using market-based systems to generate both social as well as financial returns has been notably promoted in the USA over preceding decades, witnessed by the introduction of the term "impact investing" and related themes such as "blended value" and, more recently, "shared value". The term PhilanthroCapitalism was coined by British authors to highlight how principles of business can be successfully combined with the creation of social good. The philanthropic sector in the USA has traditionally been considered more financially innovative than in the UK. This has often been attributed to the legal requirement for minimum annual grant-making payouts (5% of endowment capital), which calls for much more aggressive investment strategies to sustain. For example, the USA introduced the Low-profit Limited Liability Company (L3C) legal form to bridge the gap between for-profit and non-profit organisations.

THE NON-ANGLOPHONE DEVELOPED WORLD

EU Commissioner Michel Barnier, responsible for the internal market and financial services, launched a consultation in July 2011 on how private investment can play a greater role in supporting social business. He has also called for the establishment of a European social bank to catalyse the market. The prospect of attracting private capital to finance the social sector across Europe is particularly welcome at a time of severe budgetary constraints at European Commission level and also fiscal austerity at national level. Long-standing EU principles of free movement of capital and the cross-border supply of financial services create an opportunity for UK and European organisations to collaborate in the development of hybrid social impact investment models that combine the respective strengths of market-based systems and solidarity-based investment. Precedents of this already exist; an example is UK microloan provider Fair Finance, which secured £2 million worth of commercial banking package from European banks Société Générale, BNP Paribas and Santander, leveraged using £750,000 of patient philanthropic capital and a £350,000 loan from the Big Society Finance Fund.

THE DEVELOPING WORLD

Social impact investment is truly a global phenomenon – not only is there great need for social impact investing in the developing world but there are also brilliant exemplars and highly innovative organisations such as the California-based Omidyar Network,13 a global philanthropic investment firm that invests in non-profit and for-profit organisations to improve peoples' lives through harnessing the power of markets. The wide range of locally developed models is also encouraging, such as the Sitawi social fund in Brazil, which provides loans and advice to social purpose organisations, and Aavishkaar in India, which provides risk capital to social entrepreneurs at the "base of the pyramid". The CiYuan initiative in China is an incubator that builds cross-sector partnerships to enhance the value of social impact investment in China and improve the capacity of local foundations and NGOs. NeXii in South Africa is an organization that focuses on building marketplace infrastructure for social impact investment and is currently collaborating with the Stock Exchange of Mauritius to create a dedicated board on its exchange that will enable social purpose organisations globally to publicly raise debt or equity in US dollars, euros and sterling.

sector3 CONSULTORIA DE GESTÃO

THE FINANCIAL CASE FOR DEBT INVESTMENT (three key aspects)

ATTRACTIVE YIELD: The Social Investment Business charged out its loan capital on most of its funds at a fixed rate of 5–6% per year. Typically capital providers and intermediaries are set up as non-profit organisations, which by definition do not need to make a profit and can therefore set the rate as low as possible and recover the cost of capital, management fees and absorb defaults based on the given risk exposure. Over time, further independent performance statistics and the expanded provision of different financing products with different maturities will also allow a yield curve to develop for this asset class, which will help further establish its transparency as an asset class and better enable comparisons of yield relative to credit standing with other asset classes. Such an asset class and alternative investment market will be attractive to some investors as long as the risks are assessable and not "black hole" risks.

ASSESSABLE RISK: Risk in social impact investment, certainly in the debt segment, is assessable. An assessable risk level comes from the emerging track record and credit statistics of social impact investors and the established rate of write-offs in the sector. Similar to the path taken by all emerging markets more transparent information and robust track records are emerging, which remove the initial "black hole" risk characteristics associated with the asset class (as with many new markets at inception) and over time will instil more confidence in investors. The cumulative write-off rate for investments made by the Social investment Business is less than 5.0% across the portfolio, while for CAF Venturesome the aggregate is 4.0%. the social impact investment market offers higher but now assessable risk in exchange for a reasonable level of yield, consistent with emerging markets. The social impact return on these investments is then an additional return that helps provide the motivation for investing in the sector at all.

DIVERSIFICATION BENEFITS AND LOWER CORRELATION: A challenge of mainstream investment over the past 10 years has been the increased correlation between many different mainstream financial markets and the increasing difficulty of finding real diversification. Instinctively, investment in the social sector should offer some lower correlation and some real diversification benefits. Indeed, demand for the products and services of the social sector is intuitively either non-cyclical (for example, demand for care driven by mostly demographic factors) or in some cases countercyclical (for example, demand for charitable services typically increases during recessions).

NEW PRODUCT DEVELOPMENT

I - EXTENDING CLASSIC LOAN STRUCTURES TO THE SOCIAL SECTOR

- Different maturity loan products, to provide a range of shorter and longer-term maturities;
- Working capital revolver loans, one-year and longer-term working/development capital;
- Other revolving facilities that allow loans to be redrawn within the facility period;
- Set-off loan and deposit products;
- Greater range of unsecured loan products;
- Loan products with risk-adjusted interest rates;
- Guarantee products and underwriting of mainstream loans (or tranches of them) to the sector;
- Loan guarantees.

II - FOLLOW-ON FUNDING AND MATCH FUNDING

- Second, third and fourth-round financings to reward success;
- A greater range of match funding and coinvestment products, based on formal or informal partnerships with mainstream financial institutions (this could involve a shared agreed approach to credit appraisal, covenants and information requirements).

III - TAILORED PRODUCTS FOR THE SOCIAL SECTOR

- Continuation and development of an “engaged investor” approach to loanmaking, with business support included but not necessarily within the same investment organisation;
- Patient capital approach within loans – matching capital and interest payments to income flows and/or social impact profile;
- Performance-related loans, potentially allied to longer-term unsecured loan note products that provide simpler alternatives to social impact bonds.

IV - SPECIFIC PURPOSE LOANS

- Refinancing loans;
- Merger loans;
- Modernisation/management development/financial system development loans;
- Bridging loans.

V - PACKAGED PRODUCTS

- Packaged loan and grant offers;
- Packaged loan and business support offers.

VII - COLLECTIVE PRODUCTS

Pooled funds and stakes in funds-of-funds for retail and institutional investors

VI - PRODUCTS FOR FOUNDATIONS

Programme-related investment (PRI) and mission-related investment (MRI) products across a range of intermediate capital types and a range of programme areas.

sector3 CONSULTORIA DE GESTÃO

CONCLUSIONS

Three major themes surfaced in undertaking this review, namely that social impact investment exists within an emerging market, that to succeed it needs to be an integrated market, and that these investments primarily comprise intermediate capital.

AN EMERGING MARKET
We assert that there is now already sufficient momentum that it should be a five-year project, not a 25-year one, to mature the social impact market to the point where it is unexceptional for mainstream investors to be engaged in it as an alternative investment market.

AN INTEGRATED MARKET
Social purpose organisations should be able to confidently develop financing strategies to support their missions and growth plans, and they should not be forced to rely on sequential one-off rounds of funding but rather have access to a funding escalator that rewards success with follow-on investment.

AN INTERMEDIATE CAPITAL MARKET
Debt in an intermediate capital context is a very flexible financing instrument and can be tailored, such as patient capital and participating capital, to meet the needs and risk profiles of social purpose organisations. Debt investments that are structured as intermediate capital also have the potential to offer investors attractive yield, portfolio diversification through weaker correlation with mainstream markets and assessable risk resulting from the growing performance data of existing funds and investments.

sector3 CONSULTORIA DE GESTÃO

“There is a lot to be excited about in this emerging market. Entrepreneurs in the social sector need access to risk capital, often in the form of hybrid securities. The sector needs multiple capital providers whose management teams understand finance. There is also a need for brokers who bring together those who require capital with those who would like to provide it. I encourage anyone with the right skills to get involved in developing this important social market.”

SIR RONALD COHEN